THE FINANCIAL POLICY OF CORPORATIONS

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CONTENTS

VOLUME V

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CHAPTER I

THE PROBLEM OF REORGANIZATION

When a corporation fails or becomes embarrassed, its financial plan is usually remolded. This is reorganization. It is a redrawing of the financial plan, but with a view to contraction, not to expansion.[1] Whether the new plan provides for contraction or expansion, new money is required, but an expanding and profitable business may ordinarily solicit new capital on the basis of its past success, whereas a bankrupt business secures capital only through coercion. Unwillingly its security holders add more money merely to save that already invested. So easy is it to obtain money for the expansion of a successful business by one of several ways, that the question is merely one of financial expediency; so difficult is it, on the other hand, to obtain the money necessary to reorganize an unsuccessful corporation, that the success of the reorganization depends primarily on selecting that plan which shall achieve this one end with the least friction.

Owing to the delicacy of the situation and the judgment required, corporate reorganization is the most intricate phase

[1] In this volume the term "reorganization" does not include those corporate changes which result from governmental suit brought under the Sherman Act of 1890, or the English common law of restraint of trade. Nor does it include those reorganizing changes resulting from the union of a group of successful or partially successful competitive units into a single organization. If cases arise that make it necessary to use the term in a significance that includes any such instances, the fact will be clearly indicated.

of the whole field of finance, and the one in which generalizations and precedents are least significant. It is a subject which has as its elements a mass of conflicting legal precedents, the makeshifts of mere temporary expedients, and, permeating the whole, the psychological bias and prejudices of thousands of dissatisfied human beings whose interests are in fundamental conflict. The primary purpose of every reorganization is justice to all concerned. But the justice is tempered—one might almost say obscured—by motives of expediency. Compulsion is exerted at one or more points. This requires the arm of the law; yet the whole subject is so new that there are few laws to cover it[2] and very frequently a state statute may be in direct conflict with an otherwise expedient reorganization.[3] Moreover, even when the statutory law presents no difficulties, there are always conflicting precedents and legal opinions.[4] In addition to the legal aids and impediments, there are important financial questions of mere judgment—the ease with which an underwriting may be obtained, to what extent the stockholders may be counted on to add money, what may be the opportunity for selling bonds during the first year of the new company's life. In answering these questions in any one particular case, precedents are of little value. Each reorganization is different from all that have occurred before in one or more important respects. And some particular may be such as to require that a plan, otherwise practical, be set aside. The only general principles, therefore, that one can formulate are at most approximate summaries having little more than an historical significance.[5]

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[2] Some states have special laws affecting reorganizations, notably New York, Michigan, Pennsylvania, New Hampshire, and West Virginia.

[3] Thus Texas had a law permitting purchasers of railroads to form *one* corporation to take over all the assets, claims, and the like of another. (Revised Statutes, Sec. 4359.) The old Houston and Texas Central Railway was sold in two parcels and thus disintegrated into two railways. The law required one corporation for successor, and as here were two, the law had to be changed to meet the difficulty.

[4] Notably in the claims of the merchandise creditors that can be placed ahead of the claims of the holders of funded debt. See Chapter V, page 97.

[5] The ablest practical master of reorganizations we have ever had remarked: "You may deduce rules of law easily enough, but it is not as easy to deduce

Yet in spite of the intricacy of the subject, it is one of the most important in the field of finance. In the past, hundreds of millions of dollars of actual property investment have been involved in reorganizations. Great railroad systems like those of the Atchison and the Reading,[6] great traction systems like those of the New York City and the Chicago surface lines, great manufacturing industries like that of the Westinghouse Company, involving thousands of laborers and the production of necessities of modern civilization, have all been subjected to the uncertainties of reorganization. These enterprises have involved much more than the mere fortunes of the wealthy; they have been concerned with the savings of a great multitude of people, including the very poor. Frequently the savings of a man's lifetime have been jeopardized by a single man's interpretation of justice in a reorganization plan. Probably the ablest men in law, finance, and productive industry have given some of their best efforts to the solution of the intricate problems involved. The regrettable feature is that in spite of all precedents, each new reorganization is quite as perplexing as those that have gone before. Certainty and permanence in the theory and practice of corporate reorganization constitute as yet an unattained ideal.

The reorganization of a large corporation is the result of failure.[7] This failure is distinctly different from that of

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rules of business having a general application, except a very few simple ones; for a reorganization is a mass of details, differing in each instance, varying with all the conditions, presenting novel questions of finance, often wholly unanticipated. If in your own minds you may think at times that you have evolved some important general principles to be followed, you will probably find it wise to forget them on the first occasion when you attempt to apply them." Joline, A. H., Lectures delivered before the Graduate School of Business Administration, Harvard University (1909).

[6] Between 1884 and 1899, a period of fifteen years, 521 railroad corporations were put into the hands of receivers. In the aggregate they controlled 78,582 miles of line, with over five billion dollars capitalization, divided about equally between stocks and bonds. Figures given in Poor's Manual of Railroads, lxxi (1900).

[7] Cravath qualifies this generalization, when he says, "Corporate reorganizations usually, though not always, follow, and are based upon, the foreclosure of mortgages or the enforcement of the rights of creditors in some form," but the context shows clearly that he is considering the legal rather than the economic aspects of corporate reorganizations. See Cravath, P. D., in Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 154 (1917).

This emphasis on failure is evident in a lecture by Thomas W. Lamont in

a partnership. In the latter case the business would ordinarily have no bonded debt, and the bank and merchandise creditors would either force the business to liquidate, or else compel the partners to offer some plan involving the partial or complete payment of the debts. The case of the small corporation is similar. In the case of a large corporation, on the other hand, there are many different persons interested in the business. It is a complex organization. No one is personally liable for the debts in case, on liquidation, the business does not sell for the amount of its liabilities. Furthermore, the large business has usually valuable intangible assets such as good-will, which retain a value only if the business is continued. So that even when it appears that the business may be disintegrated, and the parts sold for an amount sufficient to meet the creditors' claims, the stockholders themselves will probably deem it expedient to invest sufficient new money to pay these claims immediately, and thus save the business and its organization from complete disruption. In this way a new or reorganized business, free from immediate embarrassment, starts with the same stockholders as the old.

If the corporation furnishes a public service, it cannot be closed up, even if the various parties concerned are willing. The courts take the attitude that a railroad, an electric light or a gas plant, supplies a public necessity, and that the rights of the public come before the wishes of the stockholders or even the debts of the creditors. Except in extreme cases, when there is abundant evidence to show that there exists no public need, the courts will insist that the embarrassed corporation shall operate its trains or its lighting plant through

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which he said that a reorganization might imply "a decision, brought about usually by a company's success, to enlarge it, to recapitalize it, or to amalgamate it with some other corporation or corporations. But such a reorganization falls more properly under the head of combinations and consolidations. We shall confine ourselves to the reorganizations that are brought about by unsuccess, failure and even bankruptcy." Lecture before graduate School of Business Administration, Harvard University (February 5, 1909). The tendency of business and legal usage during the ten years since this statement was made is to confine the term more and more to cases of "unsuccess."

the agency of a receiver, and that its stockholders and creditors shall ultimately adjust their difficulties and reorganize the corporation so that it may continue its business as a solvent and progressive enterprise. The court may even issue securities in the name of its receiver which take precedence over the claims of every creditor of the corporation; it may decide which creditors' claims shall be paid and which shall not; and it may otherwise conduct the business in an arbitrary manner, provided such usurpation of power is necessary to safeguard the interests of the public. From all these causes the probability is very slight that an unprofitable or bankrupt business, meeting an obvious need of the public, will be disintegrated and the parts sold;[8] it will be voluntarily or forcibly reorganized.

It is extremely difficult to formulate an adequate definition of corporate reorganization which shall include neither too little nor too much. It is more than a mere extension or contraction of capitalization, yet it does not include every recasting of the financial structure of a corporation. In common usage the term implies a redrawing of the financial structure of a corporation in consequence of threatened or actual insolvency. That is as clear a definition as one may give. More exhaustive definitions quite generally are useless, unless restricted to special forms of corporate enterprises, which renders them of no value when applied to corporations in general.[9] Gradually the term "reorganization" is being more

[8] There are, certainly, exceptions. Even railroads have been torn up and the parts sold, but the instances represent railroads for whose existence there was no obvious economic or social excuse.

[9] Financial literature is full of definitions of reorganization, most of which apply intentionally to a specific group of corporations. Perhaps the best, although rather cumbersome, is that of Cravath: "The term 'reorganization,' as applied to corporations, may somewhat loosely be defined as the rearrangement of the financial structure of an incorporated enterprise, rendered necessary by insolvency or by the inability of the corporation to secure funds for its operations because of obstacles resulting from its financial structure." Cravath, P. D., in Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 154, (1917).
Similar definitions are: "Reorganization may be said to consist of the rehabilita-

and more restricted to those cases of comprehensive financial readjustment adopted in the presence of real or threatened financial embarrassment, in order that the business of the corporation may be continued under more favorable conditions.

Although the period of reorganization is frequently long extended, it is usually possible to distinguish two distinct stages. The first is the diagnosis of the corporate malady, represented by the period required for the investigation and isolation of the causes that led to the financial disaster.[10] The

tion of an insolvent business through the adoption of a new financial plan." Walker, W. H., Corporation Finance, 311 (1917).

"The reorganization of a bankrupt corporation is a settlement of the claims of the different parties in interest on such a basis that the property can be released by the court and again managed as a going concern." Meade, E. S., Corporation Finance, 427 (1915).

Specific definitions of railroad reorganization are more numerous. Some of them err in being so specific as to exclude many cases of undoubted reorganization, as for example: "The term 'reorganization' is used in this study to denote the exchange of new securities for the principal of outstanding, unmatured, general mortgage bonds, or for at least 50 per cent of the unmatured junior mortgages of any company, or for the whole of the capital stock." Daggett, S., Railroad Reorganization, 335 (1908).

In the course of an able discussion of the current definitions of railroad receivership and reorganization, Ripley describes reorganization as "the financial readjustment or settlement necessary for the restoration of peace and order, generally through the re-establishment of a proper equilibrium between income and outgo." Ripley, W. Z., Railroads, Finance and Organization, 372 (1915). Another definition of railroad reorganization is: "A comprehensive change of the financial plan, necessitated by impending or actual failure, such that the fixed charges are reduced and new money supplied through the sacrifices of security holders." Dewing, A. S., 8 Am. Econ. Rev., 778 (Dec., 1918).

Cleveland and Powell restrict railroad reorganizations to "those proceedings by which the affairs of a corporation are closed out through judicial sale and taken over by a new corporation." Cleveland and Powell, Railroad Finance, 249 (1912). It is probable that this is too narrow for even railroads. It certainly is, for all corporate reorganizations.

With special reference to the complexities and varieties of industrial reorganization, the following was used: "A corporate reorganization is the form of financial readjustment adopted in the presence of real or threatened financial trouble, in order that the business of the corporation may be continued under more favorable conditions." Dewing, A. S., Corporate Promotions and Reorganizations, 7 (1914).

One writer seeks to confine the term to these cases of actual foreclosure. "When they (extraordinary changes which may take place in the financial plan) accompany foreclosure we say the corporation has gone through a 'reorganization.' If the change in the plan of capitalization takes place as a result of insolvency without foreclosure, we may say that the corporation has undergone a 'readjustment of the capital account.'" If this distinction were accurate, one could not call the Baltimore and Ohio and Westinghouse reorganizations by that name—which is certainly contrary to customary practice.

[10] Very often just before the failure of an enterprise the services of a "financial doctor" are sought. Ordinarily a man known to have been successful in the past in rehabilitating distressed businesses—often nominated by the banks or large creditors—is placed in charge of the enterprise and dictatorial powers delegated to him. He is generally compensated on some contingent basis—an option on a block of stock or a specified fee, provided his efforts meet with success, and nothing if he fails.

The earliest historical case of this, and one closely resembling the present

second is the reorganization proper, in which some plan is agreed upon and finally carried into execution. The next succeeding chapter discusses the more frequent and potent causes of failure, and the succeeding chapters deal with the reorganization proper, its procedure, the conditions for its success, and the typical plans that have been used in the past for railroad and industrial reorganizations.

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customs, is that of the Vermont Central in 1850. The road found itself in serious financial straits. Accordingly Josiah Quincy, Jr., son of President Quincy of Harvard College, and then known as a successful railroad promoter, not over-scrupulous but energetic, was given an option on 50,000 shares of the railroad at $50 a share. He was to take the treasurership, become its chief executive, and complete the unfinished road to its northern terminal. (Report of Investigating Committee, Stockholders Vermont Central Railroad, 1853.) He failed in the endeavor, so that his option became worthless.

CHAPTER II

CAUSES OF FAILURE

Distinction between the fundamental and the superficial causes of failure, 10; Four fundamental causes of failure, 11; Competition, 11; Unprofitable expansion, 14; Cessation of public demand, 21; Excess payments of capital charges, 22; Superficial signs of failure, 26.

In discussing the causes of corporate failure, it is convenient to distinguish between three phases of the general subject—the fundamental causes of failure, the superficial causes or conditions, and the outward signs. These three are usually confused, even by economists. We may go even further and say that ordinarily neither the men who are responsible for the business failure nor the financial experts who constitute themselves an investigating committee, ever note the important difference between the fundamental and abiding causes of financial distress, and the mere external symptoms that stand out clearly in the foreground. Business men are usually unreflective—in a very true sense, that makes them aggressive and quick of response, because action is not imperiled by irresolution. It does not, however, make them successful in diagnosing their own troubles or those of their associates. They cannot see the causes of business failure in their true perspective.

For the present analytical purpose it is preferable to consider first the fundamental causes of business failure, and from these move outward to their more external conditions and effects. One of the most significant criticisms advanced by the Austrian school against the classical economic theories

of Mill and Cairns was that economic values cannot be isolated from their setting, but on the contrary, are superimposed on psychological values. Nowhere is this truer than in the matter of business success and failure, for, after the most exhaustive and illuminating analysis of economic causes, there must stand out always the fact that a business fails because the managers do not possess the necessary intuitive skill, foresight, initiative, perseverance, and intellectual power to compel its success. Any discussion of economic advantages or disadvantages must be subordinate to the conscious recognition of personal characteristics.

Yet, recognizing fully these psychological conditions leading to failure, one may still speak of fundamental economic causes, in the sense of economic conditions which will, under the leadership of any but a business genius, lead to failure. In this category may be included four—excessive competition, unprofitable expansion, a change in the public demand for the commodity, and the distribution of capital as ostensive profit.[1]

Competition is a necessary and wholesome element in all business enterprise. Within broad limits, the keener the

[1] As a preface to the survey of corporate reorganization, other writers have emphasized other causes and conditions of failure. Surveys of the causes underlying railroad failure have been very common. One of the earliest was that of Simon Sterne who laid stress on the undermaintenance of new roads built from the sale of high interest-bearing bonds and running through undeveloped country. 10 Forum, 39 (1890). He discussed the same subject some four years later after the failures accompanying the panic of 1893 and found the chief cause to be in the inadequate number of able railroad entrepreneurs. 17 Forum 26 (1894). One of the latest discussions is that of Ripley, who finds four reasons for railway failure—overexpansion, overcapitalization, fraud, and internal dissension. Ripley, W. Z., Railroads, Finance and Organization, 378 (1915). In a remarkably keen analysis of the Rock Island Railroad's financial distress, written when its reorganization was a matter of public discussion, Theodore Prince states four causes for the bankruptcy of railroads: (1) decrease in earnings owing to decreased efficiency or decrease of business; (2) increase of fixed charges at a rate more rapid than the increase of earnings; (3) undermaintenance; (4) unfortunate investments. Prince, T., "The Rock Island," 19 Moody's Mag., 409 (Aug., 1916). In the industrial field, the favorite explanation of failure is overcapitalization. The deflection of earnings to the payment of capital charges has been given as a chief cause. Dewing, A. S., Corporate Promotions and Reorganizations, 557 (1914). It is probably impossible to classify business failures with sufficient precision to bring to light a series of elementary causes so clearly defined that all students will agree upon them.

competition, the greater will be the business efficiency and the higher the range of executive ability required for success. It becomes a true cause of failure only when it becomes so keen that the most efficient competitors are required to sell at less than cost. In the case of a business requiring small capital, a business which can be created or liquidated in a short time, the most efficient will never be compelled to sell for less than cost. Instead, the less able managers of the less efficient plants will wisely stop producing or even retire from business. But if large amounts of capital are invested or if the service is required by the public, or if the business carries itself forward by the sheer momentum of its past, it can neither stop producing nor go into liquidation. A railroad is a case in point. It cannot cease to exist.[2] If the rates it collects for its services are insufficient to pay for its operation, it must still run its trains.[3] And the rates a railroad may collect bear no immediate relation to cost. They are purely competitive in that the heavy capital investment of the railroad's plant requires that freight be taken, although it returns just a little more than the mere cost of operation. Social and economic conditions require that the road be operated even though there is no return on the investment.[4]

[2] An interesting example of a railroad going into liquidation is that of the Buffalo and Susquehanna Railway. See Chapter VII, note 39.

[3] For example, in a country even as thickly settled as New England, a large proportion of the passenger trains operated do not pay their expenses. It cost (using the statistics for eight months ending February 28, 1915) the New York, New Haven and Hartford Railroad $2.07 per train-mile for all trains, without taxes or fixed charges. During the test period from January 18 to 31, 1915, 316 out of 2,098 passenger trains earned over $2 per train-mile. In other words, only 15 per cent of all the passenger trains run by the railroad paid their proportion of the total operating costs of the road, provided it may be assumed that train operating costs may be evenly distributed. Even if this is not accepted and the train-mile costs for the freight and passenger services are separately computed, it is improbable that half the passenger trains on any large, widely extended road pay the direct costs of operation. Statistics from an address by Howard Elliott at Norwich, Connecticut, April 8, 1915.

[4] Suppose it costs $1 a mile in direct expenses to operate a certain train. This sum pays merely the expenses which would not be incurred if the train were not run, but it does not include any share of the costs of the central office, the maintenance of the road, or the interest on the funded debt. Under normal conditions the railroad would charge such rates that the train would yield not only $1 per mile, but sufficient as well to meet the proportionate general expenses and to make some return to bondholders and stockholders. But suppose the same charge had to be met by a train of a competitive line when there was hardly freight enough to warrant the operation of a single train. Clearly each railroad would carry freight

Competition is most severe in businesses analogous to that of the railroad, where the things bought are never the things sold, so that the determination of the cost of production is entirely a problem of accountancy. Between the years from 1885 to 1893 most of the western transcontinental railroads failed. The reason was simple.[5] Too many roads had been built to carry the traffic at remunerative rates. It was clearly a case of excessive competition brought about by unwarranted railroad expansion.

A local public service company is ordinarily protected by the utility commission of the state in the exercise of monopoly powers, provided it renders good and reasonably cheap service to its customers. Competition is a relatively unimportant factor for such businesses, unless one considers the competitive influence of two utilities—gas and electricity, omnibuses and street-cars. In manufacturing businesses the plea of severity of competition can be advanced but seldom as a fundamental cause of failure. A manufacturing business can curtail production even at the expense of its organization, rather than dispose of its product at less than cost. It is true, competition is alleged to be the cause of many failures,[6] but the allegation is merely an excuse to obscure the deeper defect in business management. Too keen competition is invariably the excuse of the weak.

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at the rate that secured the most business, and it would seek to obtain the most business by reducing the rate. No freight would be taken by either road if the yield per train-mile were less than $1. But any rate above this would contribute something, however small, to those general expenses of the road that continue whether the train runs or not. The competition between the roads would drive the rates so low, in fact nearly to $1 per train-mile, that not only the margin of profit would disappear, but the margin of general and maintenance expenses. As a result, both roads would fail.

[5] In a careful study of the causes of the railroad failures of 1893, Simon Sterne mentions as particularly important the inability of the country to develop sufficient railroad entrepreneurs to manage the large number of roads which had come to form the American railroad network. He does not emphasize the cause here given, although he is led to consider the influence of cost of service on the rates and earning capacity of the railroads. Sterne, S., "Recent Railroad Failures and Their Lessons," 17 Forum 19 (1894).

[6] Notably, the various failures of such continuously unsuccessful enterprises as the cordage, cotton duck, strawboard, salt, writing paper, newspaper, and steam pump combinations, when the true causes lay outside the precincts of economics. In each case the cause of failure was the sheer lack of business ability of their managers to meet such competition as was inherent in the industry.

Unprofitable expansion is a much more serious and a much more common cause of failure than drastic competition. It is the besetting sin of a fairly successful corporation, with a relatively large margin of gross profit based on a small output. It is also the usual cause of disaster among corporations favored with an unusual capacity to borrow money. While overmastering competition occurs only when there is a large capital investment, the temptation to overexpand is present in every business. It is commonest in a country like the United States where the margin of profit shows marked fluctuations and where the temperamental bias of optimism is magnified by an inclination to regard hopes for the future as things predestined. As a keen judge of business conditions remarked to some students, "When you have a business that is growing very rapidly, you are apt to be a little blinded by the rapidity of it, and look at your gross sales rather than your net profits." [7]

The number of instances in which the cause of failure is overexpansion are legion, but for the present purpose it suffices to note three drawn from the manufacturing, the public service, and the railroad industries.

One of the striking instances of failure due to overexpansion of an otherwise successful manufacturing business is afforded by the history of the Westinghouse Electric and Manufacturing Company.[8] Starting in 1886 with sales amounting to less than $150,000, the business grew by leaps and bounds. During the year 1894, a period showing relatively little business activity, the Westinghouse Company, on a capital including bonds and current debts of less than $10,000,000, showed a net profit of over 16 per cent. Expansion continued. The company organized foreign departments

[7] Thomas W. Lamont, Lecture before the Graduate School of Business Administration, Harvard University (1909).

[8] For further details concerning the history of the Westinghouse Electric and Manufacturing Company through its last reorganization, see Dewing, A. S., Corporate Promotions and Reorganizations, Chap. VII.

and finally foreign factories. It financed interurban electric railway lines for the purpose of exploiting its inventions; it advanced large sums to unproductive subsidiary companies. By 1906 its total funded and current liabilities and stock had risen to $45,000,000, but the net profit was only a little over $3,000,000, or only 5 per cent. No theoretical economist ever discovered a clearer illustration of the law of diminishing returns. As a small business in a year of depression, the Westinghouse Company earned 16 cents on every dollar of invested capital; as a large business in a year of marked prosperity, it earned 5 cents on each dollar. It failed the year following.

The second type of illustration comes from the field of the holding company, or more particularly the public service holding company. As explained in another connection,[9] this type of enterprise became very popular in the years following the panic of 1907 when capital was seeking new channels of investment. The first two or three of these companies were successful from the beginning, notably the original United Gas Improvement Company, and later the American Light and Traction and the American Gas and Electric companies. In finance as in all other fields of endeavor, there are always hosts of imitators whenever a new development seems to point the way to an easy success. Public service holding companies sprang up all over the country. As their profits consisted entirely in the increment of earnings remaining to generous issues of common stock of the local operating companies, it seemed to the operators of these companies that the greater the number of utilities controlled the greater must be the profit. The success of the American Light and Traction Company was due to the careful selection of properties to be acquired, conservative management, and shrewd finance.[10]

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[9] Volume IV, Chapter V.

[10] As an example, the Milwaukee Gas Light Company, one of its underlying companies, was able to issue a 4 per cent bond which was acquired by investors

Its imitators, however, lacked these three elements of success—they lacked particularly care in selecting new properties. Economy was sacrificd to mere size. This foolhardy mania for expansion reached its climax toward the end of 1911 just before the decline of the stock market values which ended in the close of the Stock Exchange July 30, 1914. Subjected to a shrinking market for credit, these recently organized holding companies were in dire straits. Most of them resorted to the issue of short-time notes, either to meet the demands of their subsidiaries, or to fulfil already existing contracts. Some of them used borrowed money to maintain the interest on their bonds.[11] Several went into the hands of receivers. Others passed their preferred stock dividends or gave scrip for them. They all advanced excuses—a tight money market, increased taxes and labor costs of the operating companies, and latterly a difficulty in selling securities because of the Great War. But the fundamental reason was not given. The companies had spread their resources and their credits so thin that the cover had begun to break.

In the field of railroad enterprise, the influence of unwise expansion[12] was much more potent than that of keen competition even during the decade before the panic of 1893, although excessive competition has been advanced as the primary cause of the numerous receiverships of that time. When the Northern Pacific passed into the hands of receivers, the road was facing an annual loss of over $1,500,000, caused very largely by its unprofitable branch extensions.[13] The Atchison, in its foolish expansion from 1884 to 1888, illustrates the principle clearly.

at an income rate unprecedented for public service companies outside of Maine, Massachusetts, and Connecticut.

[11] The Northern Idaho and Montana Power Company, a subsidiary of the Standard Gas and Electric Company of Delaware. See Chapter V, note 3.

[12] This cause as a basis for railroad insolvency has been discussed by many writers. See particularly Cleveland and Powell, Railroad Finance, 219 (1908), and Ripley, W. Z., Railroads, Finance and Organization, Chap. XIV (1915).

The subject of railway expansion and consolidation has been discussed already in Volume IV, Chapter IV. In that connection the course of railway expansion was outlined without reference to its evil consequences if carried to excess.

[13] 57 Chron., 854. It has been suggested that these unprofitable branch lines

In the former year with 2,800 miles of line the road made net earnings of $2,600 a mile; in the latter year with 7,000 miles of line it earned only $700 dollars a mile.[14] In the former year the road had over $5,000,000 available for its stockholders, in the latter year there was a net deficit of $3,000,000. Looking at the matter another way, the Atchison system earned 6½ per cent on its total outstanding bonds and stock in 1884, 2½ per cent in 1888.[15]

Among eastern roads the failure of the Reading in 1880 was due directly to the purchase, at a cost of $73,000,000, of coal lands valued at the time at $30,000,000,[16] and the receivership of 1884 to the lease of the Central Railroad of New Jersey which guaranteed a dividend of 6 per cent on its stock when the interest on its bonds was not earned. The Reading's failure of 1893 can be traced to the burdens of the Central New Jersey and Lehigh Valley leases, together with wild speculations in the stocks of New England railroads.[17]

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are necessary for a large railway in order to develop traffic. This is nonsense. Daggett, S., Railroad Reorganization, 281 (1908).

[14] These figures taken from the two tables given by Daggett. Total Atchison system.

	1884	1888
Mileage	2,799	7,010
Bonds	$48,258,500	$163,694,000
Stock (Atchison)	60,673,150	75,000,000
Gross earnings	16,699,662	28,265,339
Operating expenses	9,410,424	21,958,195
Net earnings after fixed charges (before interest on floating debt)	5,147,883	deficit 2,933,197

Daggett, S., Railroad Reorganization, 198 (1908).

[15] At the beginning of this period of expansion, the editor of *The Commercial and Financial Chronicle,* while commenting favorably on the general policy, states: "As regards the Sonora purchase, results have not justified it from a financial point of view at least. The road entails a large annual loss. Its utility, too, as a Pacific Coast connection has proved visionary." 40 Chron., 468 (April 18, 1885). The Sonora line was representative of most of the purchases made during the period.

[16] Figures and details in Daggett, S., Railroad Reorganization, 78 (1908). Although perhaps a valuation of $30,000,000 might have been made at the time, subsequent events have shown that the Reading's coal lands are of almost incalculable value. The point is, the Reading could then ill afford the capital expenditure, no matter what the real value of the land.

[17] "Mr. McLeod, the President of the company, entered on his individual account into a venture involving the purchase of a very large amount of stock, and was called upon to furnish $350,000 of a certain class of bonds as 'margin.' Having only $320,000 of his own, he secretly appropriated $30,000 from the treasury of the company, mingling them with his own to make up the amount. Shortly afterward, being in need of further 'margin,' he had recourse to the company's treasury in the same manner. After he had thus taken $842,000 of securities from the treasury, and when there was a loss of about $420,000 on the venture, the board of directors of the road was convened; and his action was, in general terms, approved. The preamble to the resolution upon which this approval was based stated the amount

So that each of the three failures of the Reading can be attributed, unhesitatingly and without a suspicion of doubt, to unprofitable expansions.

The most conspicuous railway failure of the last few years due to unprofitable expansion is that of the New Haven system. Brushing aside for the moment all the secondary causes that led to one of the most unfortunate and unnecessary failures of railroads, the primary fact stands out that the New Haven Railroad itself was ruined by the insane craze of its bankers and directors so to extend its sphere of control as to embrace a monopolistic system of transportation covering all of New England.[18] Sustained by the hope of ultimately securing monopoly profits and thereby justifying the outlay, stimulated by the surreptitious profits obtained by its directors, and by the ease with which it received credit from New England investors, the road plunged headlong into a series of expenditures which embraced traction companies,

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of securities withdrawn as only $613,000, and the resolution itself overstated by $30,000 the amount of the president's own securities used, he evidently continuing to consider the $30,000 which he had first taken out of the treasury as his own. Some weeks after this resolution was passed, Mr. McLeod again had recourse to the treasury for an additional amount of $250,000 in bonds, and about a month later he took a further amount of $1,500,000 in bonds and $250,000 in cash—$1,000,000 of the bonds and the cash being taken on the very day on which the company went into receivers' hands. When the attention of the court was called to these transactions, there was a loss of nearly $1,500,000, and securities to nearly $3,500,000 in par value had in the meantime been involved, and of course their absence from the treasury largely led to the downfall of the company.

"At the time when the resolution was passed, no mention whatever was made of the fact—and the directors were in complete ignorance of it—that by reason of these purchases Mr. McLeod had incurred a liability of over $6,000,000, nor did he deem it his duty to inform the board as to the number of shares he had purchased or at what price; and, instead of stating that there was a loss on the transaction, he stated that the transaction was profitable." Rice, Isaac L., "Legalized Plunder of Railroad Properties," 17 Forum 676 (1894).

[18] Much has been written by the Interstate Commerce Commission, by bankers, and by railway experts concerning the causes of the plight into which the New Haven system was driven in 1914. The whole case resolves itself, in the opinion of the writer, into very simple terms. Prompted by the apparent success which the Reading and other railroads had attained in securing to themselves a form of transportation monopoly, the directors and bankers saw in the compact area of New England an opportunity to create a monopoly of a very high degree of organization. No price was too heavy to pay if the object could be attained, no temporary sacrifice too great. Monopoly, however, could not be obtained. Economic laws could not be set aside. As a result, the integrated parts, which could produce a revenue on their purchase price only on the basis of a monopoly, became burdens rather than sources of revenue. Aside from the Report of the Interstate Commerce Commission—a very dramatic recital for a public document—one of the most intimate accounts is that given by President Mellen in a personal interview to a Boston newspaper. See *Boston Sunday Post*, November 9, 1913. Attention is called to the frequent references in Volume IV, Chapter IV, covering the early history of the New York, New Haven and Hartford Railroad.

steamship lines, connecting railroads, even gas, light, and water companies, until the legitimate profits from the railroad were more than offset by the losses on the outside enterprises. Thus in 1899, on a total capitalization of $80,000,000 including bonds and stock, the company earned, above operating expenses and taxes, almost exactly $10,000,000 or approximately 12 per cent on the capitalization. This was before any outside operations were undertaken.[19] In 1914 after the completion of the policy of expansion, the total outstanding capitalization had increased to $417,000,000,[20] while the railroad mileage stood at exactly the same figure. The net income available for interest and dividends on capital had increased to $21,500,000, but that was only 5 per cent on the outstanding stock and debt—less than half what it was before the period of outside speculations. In brief, during the fifteen years between 1899 and 1914, the railroad mileage of the New Haven system was not increased. Yet during the period, invested capital became five times as great, and the earnings only twice as great.[21]

[19] The year 1899 is chosen, as the number of railroad miles operated then, 2,047, was identical with that of 1914. If the case were to be strengthened, one could go back to 1892, to the old New Haven Railroad of only five hundred miles—that is before it began to have connecting lines. In that year the net earnings after taxes were $3,000,000 on a total capitalization of just $25,000,000—12 per cent on the capitalization. This same year was one of the most disastrous in railroad history, and roads all over the country were approaching failure. A student of railroad finance of that period might say, with ample justification that, with the possible exception of the Pennsylvania, the New Haven Railroad was in the strongest financial position of any important railroad in the country.

[20] This does not include premium realized on stock, which if added, would increase the capitalization by over $20,000,000.

[21] The law of diminishing returns finds a clear illustration in the following table:

	1892 Before Extensive Leases	1899 After Completion of Railroad System, but Before Outside Expansions	1914 Completed Structure
Mileage	508	2,047	2,046
Stock	$23,375,000	$54,641,400	$180,017,000
Bonds	2,000,000	25,836,200	237,295,254
Total capital	25,375,000	80,477,600	417,312,254
Total net earnings after taxes	3,223,965	10,014,817	21,529,186
Percentage earnings on capitalization	12%	12%	5%
Interest charges	$80,000	$1,111,071	$11,839,722
Rentals and losses on leases and guarantees	981,684	4,537,875	9,420,802
Surplus available to stock	2,162,281	4,465,971	268,862
Percentage earned on stock	9%	8%	1/10 of 1%

All these failures due to unwarranted extensions illustrate the economic law of diminishing returns. This is more than a mere academic doctrine of scholastic economists.[22] It is a vital force operating in actual business. If a certain investment, say of $1,000,000 in a manufacturing plant or a railroad, yields a net profit of 10 per cent, it does not follow that an investment twice as great will yield twice as great a profit. On the contrary, wastes incident to the bigger business will creep in, so that the profit, although perhaps greater in actual amount, will be smaller proportionately. And if the investment be continued without limit, the decline in actual earnings with the later investments will even obliterate the profit on the earlier investments. In brief, after a certain point, as capital is added to any industry, the rate of return on each dollar invested grows smaller. It is true that up to a certain point, the point of saturation, as it were, the profit tends to increase. But this point is early reached. The optimism of business men, the avarice of bankers, and the enthusiasm of engineers easily carry the business beyond it.[23]

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[22] See Volume IV, Chapter II, "The Law of Balanced Return."

[23] A remarkable analysis of the causes of a railroad failure is contained in the summary of the Report of the Interstate Commerce Commission to the Senate on the last receivership of the St. Louis and San Francisco Railroad.

"While the Frisco was compelled to borrow funds from every available source, it continued the policy of advancing money to companies in Texas. The difficulties of the Frisco were of a financial and not of an operating character. The Frisco troubles may be attributed to (1) disproportionate capitalization, (2) acquisition of new lines, (3) financing by Frisco of the New Orleans, Texas and Mexico Railroad and other south Texas lines, (4) assumption of heavy fixed charges in the acquisition of the stock of the Chicago and Eastern Illinois Railroad, (5) the sale of its securities at prices so low as to indicate a deplorably weakened credit or an extravagant arrangement with bankers to whom large profits accrued in the purchase of the bonds and the subsequent sale of the same to the public, (6) miscellaneous causes, among which are the payment of dividends upon the preferred stock in spite of its weakened credit and need of money, poor investment and expensive rentals which are the investment in the New Orleans Terminal Company stock, in the Terminal Lumber Company and rental paid the Crawford Mining Company. It appears of record, through statements secured from the St. Louis Union Trust Company, syndicate manager for the syndicates that financed the construction of a number of properties which were subsequently sold to the Frisco, and which statements were in part supported by the testimony of witnesses, that a number of lines acquired by the Frisco were purchased by that company at prices which afforded large profits to the syndicate subscribers and trust companies. Among the subscribers to these syndicates were various officials of the Frisco, including B. F. Yoakum, Chairman of the Board of Directors, as well as officers of the St. Louis Union Trust Company."

On the other side the expansion of the St. Louis and San Francisco was ardently defended at the time of its last failure by the chairman of the board who was directly responsible for it, who replied, specifically to the charges advanced in the report of the Interstate Commerce Commission:

A third, deep-lying economic cause of failure is the change in the conditions of public demand. Ordinarily a wise conservatism directs the appropriation of a portion of surplus earnings to a contingency fund which cares for the unforeseen changes in the demand for the product.[24] But sometimes these changes are so overwhelming that the corporation cannot be protected against them by any reasonable allowance.[25]

One of the best examples of the failure of a corporation due to the cessation of a public demand is afforded by the history of the American Bicycle Company. This combination

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"When the construction of these lines was undertaken in 1897, through the then sparsely settled country which has since been so largely developed through the agency of the Frisco, it was exceedingly difficult to get money for this pioneering work. Therefore, the usual plan of forming syndicates to construct and finance such lines was adopted, and in order to show my faith in the undertakings, and to secure the necessary help, it became imperative for me to invest my own funds.

"The acquired railroad properties have all proved advantageous and profitable to the Frisco, with the possible exception of the Chicago and Eastern Illinois and the New Orleans, Texas and Mexico. Judged by results at the present time, these two properties do not appear profitable, but considered from a broad, constructive standpoint, the larger plans in view, and the probable future earnings of these properties, I believe their purchase will be fully justified.

"The Frisco acquired a majority of the stock of the Chicago and Eastern Illinois Railroad Company in October, 1902, and at the time of this acquisition I did not own any Chicago-Illinois stock, nor did I make any profit, directly or indirectly.

"At the time, railroads were being consolidated into large systems, and those without access to large railroad and commercial centers, such as Chicago, could not develop their traffic satisfactorily.

"During the eleven years since the purchase of this property, the Frisco has paid out on stock certificates approximately $1,700,000 more than it has received in dividends, or an average of about $150,000 a year. The interchange of traffic, however, has resulted in gross earnings to the Frisco of approximately $3,750,000 annually.

"At the time of the purchase of the Chicago and Eastern Illinois, it practically controlled the coal traffic of Illinois and Indiana to Chicago markets. Since that time, the Southern Illinois, Big Four, and other railroads have extended their lines into that territory, and have become large carriers of coal tonnage into Chicago and other markets.

"It is believed by an expert engineer who has recently made for certain bondholders an exhaustive study and report of the New Orleans, Texas and Mexico, that the line will within three years show an earning capacity averaging $7,000 per mile gross per annum. It is also estimated, that being a low grade road, it can be operated for 70 per cent of its gross earnings, resulting in a net of $2,100 per mile per annum.

"I have endeavored to be a builder, and to aid in the creation of wealth for the country into which the Frisco lines have been projected. On the line from Houston to Brownsville, land values have increased from about $2 an acre in 1901 to from $25 to $150 per acre to-day, or probably $100,000,000 increase in value on the land within ten miles on either side of the railroad along that 400 miles. The same can be said of Oklahoma, where we pushed railroads through when it was 15 to 20 miles between houses." Letter of B. F. Yoakum to stockholders, December, 1913. All this was true enough, but neither Mr. Yoakum, nor anybody else, can build railroads for the sweet charity of boosting land values and have the roads remain out of bankruptcy.

[24] This was discussed at some length in Volume III, Chapter V.

[25] When a railroad builds a branch line to a smelter and that smelter is summarily closed because of the damage done to the neighborhood by its fumes or because of the refractory nature of the ores upon which it depends, the railroad property ceases to have value. If it is an independent railroad it fails.

acquired in 1898 some forty-eight bicycle plants producing upwards of 65 per cent of the bicycles made in the United States.[26] According to reliable auditors the annual profits of these plants had together averaged nearly $5,000,000 for the preceding four years. Appraisal by reliable independent experts showed actual property to the value of over $22,000,-000, of which upwards of $12,000,000 consisted of net quick assets. All this augured well for the combination. The total number of bicycles sold fell from 860,000 in 1899 to 100,000 in 1902. Suddenly, with no warning, the public ceased to use its toy. As a result the millions of property set aside for the manufacture of bicycles became useless and the company failed. Even after $2,500,000 in new money was added in order to adapt the factories for the manufacture of automobiles, it was not more successful. The reorganized company failed twice thereafter.

Ordinarily, fluctuations in demand are to be looked upon as normal incidents to production and are to be provided for by setting aside reserves during periods of large profits with which to meet losses during periods of restricted demand. A failure thus to provide for the normal fluctuations of trade is more a lapse of simple business judgment than the operation of anything sufficiently fundamental to be called an economic cause of failure. It is only when such fluctuations develop into far-reaching changes, such as those incident to the Great War, or when total cessations in demand arise from changes in public fancy and the advance of arts and sciences, that reasonable provisions are insufficient and the fluctuations can be regarded as fundamental causes of disaster.

The fourth of the group of fundamental economic causes of failure is entirely financial. It is the payment of excessive

[26] Figures and estimates in this paragraph taken from Dewing, A. S., Corporate Promotions and Reorganizations, Chap. X (1914).

interest or dividends due to a mistaken belief in the profitableness of the enterprise. Such payments may often be excused on the ground of unconservative but technically correct principles of accountancy—principles which, for example, may be theoretically defensible, but are unquestionably unjustifiable in practice. The corporation which employs them becomes insolvent whatever the text-books of accountancy may say. At other times the payment of interest or dividends in excess of profits cannot be justified by any theory, and can be called nothing short of fraud. Thus the American Malting Company, in a notable case that came before the courts, paid out nearly $900,000 in dividends, while its gross profit, without allowing for depreciation or special reserves, amounted to $500,000.[27] In 1872 the old Erie Railway was rescued by Daniel E. Sickles from the notorious Drew-Fisk clique. In the three following years the road earned a profit of $1,008,775, but its directors represented the profit to be $5,352,573, on the basis of which dividends were paid on the preferred and common stocks. Meanwhile, $6,000,000 of bonds were sold.[28] From 1888 to 1895, or in seven years before its failure, the Baltimore and Ohio paid out $6,269,008 in dividends, whereas an independent auditor found that less than $1,000,000 had been actually earned.[29] In 1887 the directors of the Atchison road increased the dividend rate from 6 to 7 per cent at a time when the net earnings of the road were actually falling short, by over $2,000,000, of the interest and rental requirements.[30] And this situation is present in the contemporary railroad troubles. Although the failure of the St. Louis and San Francisco Railroad in 1913 was due primarily to unprofitable extensions, it was aggra-

[27] Dewing, A. S., Corporate Promotions and Reorganizations, 286 (1914).

[28] 6 Ry. Age Gaz., 100 (1874) referred to by Daggett, S., Railroad Reorganization, 37 (1908). These cases have been previously cited in the chapter dealing with dividend policy. Volume III, Chapter VI, notes 3, 5, and 6.

[29] Daggett, S., Railroad Reorganization, 22 (1908).

[30] Ibid. 198.

vated, in no small measure, by the payment of excessive charges on the securities of the Chicago and Eastern Illinois.[31] The weakness of the Toledo, St. Louis and Western Railroad, which passed into the hands of receivers in October, 1914, was due to the excessive capital charges resulting from the burdensome charges of the Chicago and Alton Railroad.

It is important to observe also that although the occasion for the payment of unearned dividends and interest may be traced back to overexpansion, and for that reason overexpansion is to be regarded as the fundamental cause of distress, still the payment of unearned capital charges has, in many cases directly precipitated failure.[32]

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[31] See note 23 above.

[32] Closely allied with the direct payment of unearned interest by embarrassed railroads is the form of their capitalization. If, because of past mistakes and false theories of finance a railroad is overloaded with funded debt, the present management—whether or not the fault be theirs—must meet interest charges or else confess insolvency. Immediately before the Great War (July 1, 1914) there were thirteen American railroads, over a hundred miles in length, in the hands of receivers. This was before the Great War threw our financial situation into chaos, so that the causes of these disasters are to be traced to the economic and financial conditions surrounding the roads themselves. Immediately afterward the Missouri Pacific, the Rock Island, the Missouri, Kansas and Texas, the Boston and Maine, the Toledo, St. Louis and Western, not to mention other smaller roads, became insolvent. But considering only the thirteen roads which were in the hands of receivers at the opening of the Great War, the lines represented a total of 16,000 miles. The capitalization was over a billion dollars, and of this capitalization over 70 per cent was represented by funded debt bearing fixed charges. The following is the list:

Road	Mileage	Bonds	Stocks
Atlanta, Birm. & Atlantic	645	$ 19,823,000	$ 35,000,000
Chicago & Eastern Illinois	1,275	63,155,000	25,817,800
Cincinnati, Hamilton & Dayton	1,015	67,401,265	8,248,575
Colorado Midland	337	9,532,000	8,376,100
Mississippi, Oklahoma & Gulf	246	8,991,463	8,261,000
Oklahoma Central	135	3,180,000	3,193,500
Pere Marquette	2,330	66,672,000	26,242,400
Pittsburgh, Shawmut & Northern	282	14,655,600	15,000,000
St. Louis & San Francisco	6,262	291,316,691	49,985,763
Trinity & Brazos Valley	462	8,760,000	304,000
Wabash	2,515	115,181,149	92,400,427
Wabash Pittsburgh Terminal	89	55,504,000	10,000,000
Wheeling & Lake Erie	511	23,000,000	36,980,400
Total	16,104	$747,172,168	$319,809,965

Total capitalization $1,066,982,133
Percentage represented by bonds 70.1%

The largest of these roads, the St. Louis and San Francisco, had 88 per cent of its capitalization represented by bonds. On the other hand, the chairman of the board of directors of the road contended that the exigencies of state law coupled with the inheritances from the last reorganization forced him to follow this plan. In discussing the causes of the failure of the St. Louis and San Francisco Railroad, he said:

"Under the reorganization plan of 1896, the first and second preferred stocks were limited to 4 per cent, and as under the laws of Missouri railroad stock cannot

This is particularly true of railroad systems constructed out of numerous component parts, and of industrial combinations promoted in the expectation of receiving monopoly profits. Thus of 24 cases of industrial failure examined in another connection, it was found that "18 out of the 24 paid either unearned interest on bonds or unearned dividends on stock in the year just prior to the failure or reorganization," and that "every corporation paid out interest or dividends in the face of falling earnings and none need have suffered serious financial difficulties had the amounts paid in interest and dividends been conserved." [33]

While it is entirely possible and safe to draw on a large surplus in order to maintain interest or dividend payments for a single year or even two years of reduced business, the policy is at best questionable. No doubt the New Haven railroad's plight was aggravated by the fact that in the four years from 1910 to 1915 the dividend payments every year exceeded the profits available. No sufficient excuse for the mistake can be found in the desire to protect the small investor or in the hope of maintaining the company's credit among savings banks. This entire matter has been discussed in its proper place before,[34] but it is important to note again that the continued payment of interest or dividends in excess of earnings can have only one outcome, however successful the policy may appear to be for a short period.

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be sold for less than par, that plan practically prevented further sale of preferred stock. This perhaps could not be foreseen at the time of the reorganization, and I only refer to it as one of the difficulties encountered in financing the Frisco system. Therefore, the only source of financing was through bond issues." *Wall Street Journal,* December 17, 1913.

In this connection see the recital, by the Interstate Commerce Commission, of the causes leading to the failure of the St. Louis and San Francisco (note 23).

[33] Dewing, A. S., Corporate Promotions and Reorganizations, 557, 558 (1914). Swain, writing many years ago, alleged that the payment of excessive dividends was not a primary cause of railway failure. Swain, H. H., "Economic Aspects of Railroad Receiverships," 3 Economic Studies 88 (Am. Ec. Assn. [1898]). This may be true, as financially embarrassed roads ordinarily cease dividend payments some years before their failure. But no one can look back over the dividend history of the Missouri Pacific or Boston and Maine without acknowledging that at least one of the deep-seated causes of disaster was an extravagantly liberal dividend policy.

[34] Volume III, Chapter VI on dividend policy.

These, then, are the four causes underlying corporate failure—destructive competition, unprofitable expansion, a sudden cessation of demand and the payment of capital charges in excess of earnings Yet other and more superficial causes are usually advanced by corporate officials in order to explain failure. The favorite excuse for embarrassment and ultimate bankruptcy is "lack of working capital."[35] The real situation is ordinarily this. The disaster is due to some combination of the four causes enumerated in the preceding paragraphs, but the operation of the causes extends over a long period and is obscured by many subordinate conditions. Meanwhile the corporation struggles manfully to avoid the confession of failure. At first it sells stock or long-time bonds, sometimes seeking to cover up its losses by questionable methods of accounting. When the securities decline in value, as failure becomes more threatening, the corporation sells short-term notes or increases its indebtedness to the banks in the hope that a succeeding era of prosperity will enable it to refund the debt. Then, as the market for its short-term paper declines or disappears, the corporation increases the debts to its mercantile creditors. Finally, when the load of accumulated obligations becomes so great that it cannot be relieved even by

[35] This excuse has been alluded to in other connections. It makes itself felt during the preliminary discussion of almost every reorganization. In the case of industrials it is invariably used. If one should examine the host of circulars and statements made by corporation officials just prior to business failure, one would find that lack of working capital was alleged to be the chief cause of failure in the great majority of cases. It is a very plausible, and on the whole noncommittal, form of excuse. Even as keen an observer as Thomas W. Lamont mistakes the apparent for the essential when he says: "In the instance of industrial corporations, be they manufacturing or mercantile, I am safe in saying that lack of sufficient working capital stands out as the most frequent cause of disaster." Lecture before the Graduate School of Business Administration, Harvard University (February 5, 1909). Notes, page 516.

Inadequate working capital is less often advanced as the main cause of railroad failure, although instances abound. Thus President McLeod, after he had bankrupted the Reading road by burdensome leases of the Lehigh Valley and Central of New Jersey and speculations in the securities of the Boston and Maine, the New York and New England, and allied roads, naively declared at the time receivers were appointed for his road: "The trouble was brought about by the fact that we were doing an enormous business on a small capital." 18 Ry. Age, 164 (1893). The financial world was much concerned in the spring of 1893 because of the heavy floating debt of the Northern Pacific, on the eve of its failure, yet it was only the outward sign of the previous payment of unearned dividends on its preferred stock and the heavy advances to unprofitable branch lines.

extensions and renewals, the corporation confesses its insolvency, but ascribes it to lack of working capital.

Coincident with the increase in floating debt there are always numerous external signs which point clearly to the impending disaster. These all center about a gradual weakening of the corporation's credit. The corporation finds greater and greater difficulty in securing money even at increased rates of interest.[36] The company's securities decline in quoted value on the exchanges where they are dealt in, the company itself pays increasing rates of interest, and borrows on rapidly maturing, miscellaneously secured notes. If it is an industrial corporation, the ratio of bank loans rapidly increases and frequently the corporation sells its accounts receivable to "loan sharks" at prohibitive discounts. If it is a public utility or a railroad, the directors will probably resort to small temporary bank loans to finance permanent improvements.[37] And whatever the nature of the corporation, its physical property will depreciate rapidly through inadequate repairs and maintenance allowances. Frequently these symptoms of declining credit will be recognized by "the trade" [38] before they are noticed by the banks and stockholders.[39] But once they are recognized

[36] Thus the Westinghouse Company borrowed at 5.8 per cent—including the sinking of the bond discount and the bankers' commission—in 1906, the year before its failure. A few months later it was able to sell only a part of a stock subscription on a 6.7 per cent basis. Just prior to the receivership renewals were made at over 7 per cent.

[37] During the construction period money to pay contractors and to buy supplies is borrowed by public utilities generally from local banks, from directors, or even from note brokers. The plan is to fund all these debts, when the amount is sufficiently large, by the issue and sale of bonds.

[38] It is quite remarkable that the competitors of a weak industrial corporation often become suspicious of impending trouble, long before the general public or even the banks.

[39] If the stocks of the company are quoted on the exchanges, the crisis is usually heralded by a rapid and unexplained decline in the market value of its securities. At the same time there is an unprecedented volume of sales of the company's securities. Frequently these market disturbances are accompanied by reassuring interviews and comments of directors who take upon themselves the duty of publicly protecting the credit of their corporation. In one case the president went so far as to state that the earnings of his company exceeded those of the previous year—reported to be in excess of $1,500,000—when in reality they were hardly $600,000, and when interest on bonds was paid from secret borrowings. After the scandal was brought to light the same president stated publicly that the truth concerning his company's affairs "came as a disagreeable surprise." Dewing, A. S., Corporate Promotions and Reorganizations, 434 (1914).

Six months before the Atchison failure of 1893 President Reinhard is reported

and acknowledged it is clear that the financial difficulties of the corporation are of such a serious nature that mere palliatives will not rehabilitate its credit. A thorough recasting of its financial structure has become inevitable. This is reorganization.

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to have said: "The Atchison, Topeka and Santa Fé Railroad Company, strictly speaking, has no floating debt. Its current liabilities are more than equaled by its current cash assets"; whereas, at the time of its receivership, the floating debt amounted to over $10,000,000. Daggett, S., Railroad Reorganization, 205 (1908). In many cases these deceptive utterances are given an undeserved publicity by the various financial journals which stand ready to print anything that corporation officials who advertise liberally may say. Then, too, the decline in quoted values is often the result of the rapid liquidation of those close to the management who may be conversant with the real situation. The records show that at least two of the important directors of the Asphalt combination sold their securities just prior to the collapse. The investigation by the Interstate Commerce Commission of the circumstances surrounding the receivership of the Chicago, Rock Island and Pacific Railway in 1915 shows that there were many sales of the stocks by men very close to the management. There is evidence even that secret manipulation had been indulged in. There seem to be well-authenticated cases in which the same directors, who were outwardly seeking to support the company's credit by persistent reassurances to the stockholders, were at the very same time selling their own shares and even hastening the impending catastrophe by selling stock short.

The Interstate Commerce Commission, in its report to the Senate on the St. Louis and San Francisco receivership, severely condemns the artificial "propping" of a bankrupt railroad by selling bonds to the public under the misrepresentation of the road's essential soundness. "The sale of securities to the investment public through the bankers at a time when every appearance indicated the insolvency of the issuing company, invites and warrants condemnation of all those who assisted or participated in such a sale. Speyer and Company should have been aware of the poverty of the Frisco and of its difficulties in obtaining funds, as they advanced that company on April 24, $725,000 on its demand note, and $50,000 on its demand note dated April 29, and applied the proceeds of the sale, or $1,000,000 of these bonds, on May 2 to the liquidation of these notes."

CHAPTER III

THE PROCEDURE OF REORGANIZATION[1]

The procedure followed at the present time in effecting the reorganization of a large business corporation has developed through a series of precedents, each one of which was established originally more through accident than forethought. Ordinarily a fundamentally important mode of procedure, in financial as well as other social affairs, results from a slow and tempered growth of precedents, all of which are firmly rooted in the common or the statutory law, and all of which are constantly balanced off against contemporary social opinion. The history of the organization of the business corporation, the history of the public franchise, the history of the practice of corporate taxation, are all illustrations of the orderly and well-regulated development of a body of well-considered precedents, consistent at all times with the law and with public opinion. Not so the present practices governing the reorganization of financially embarrassed corporations. They have arisen through immediate necessities; they have come into existence at times when any action, legal or illegal, impetuous or reflective, was better than no action.

[1] Considerable part of this chapter has been printed under the title "The Procedure of Contemporary Railroad Reorganization," Dewing, A. S., 9 Am. Ec. Rev., 1 (March, 1918).

Three separate and often antagonistic sets of motives govern the procedure to be followed in the reorganization of any kind of large corporation. The most important and usually the least apparent is concerned with the human or psychological elements. Most writers on finance, taking their promptings from published circulars and reports, forget the interplay of human motives, ambitions, antagonisms, and friendships that underlie every financial episode of importance.[2] A corporation is reorganized by men, not puppets; its officers, its creditors, its security holders, the attorneys and the judges, are not mere thinking machines, but ordinary men, subject to human emotions and weaknesses. First then, the procedure must be such as to allay, not aggravate, the friction incident to the conflict of personalities. The second set of motives governing reorganization procedure is economic. Leases must be continued or abrogated, contracts rewritten, rights enforced or surrendered, in accordance with the single question—Is it profitable? No corporation can be permanently successful and serve the public well which does not pay its operating expenses, including fair wages to its employees, with adequate upkeep of its plant, and in addition a fair rate of return on the invested capital. And the reorganization procedure must recognize this simple economic imperative.

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[2] A writer on the recent reorganization of the Chicago, Rock Island and Pacific wrote: "Financial philosophies of all philosophies are least amenable to matters of human emotion or sentiment. Like economic laws they are ruthless and immutable. In the sound reorganization of a railroad system, certain general principles are to be borne in mind and adherence to them can safely disregard all matters of personal motive or ulterior objects." Prince, T., "The Rock Island—Reorganization by Anaesthesia," 19 Moody's Magazine, 409 (Aug., 1916). The first two sentences are flamboyant nonsense. Financial "philosophies" are amenable to human emotions, because they are based on human nature—at most a complex association of emotions, sentiments, passions, instincts, and some reasoning. The last sentence is untrue because not only must "sound" reorganizations regard personal motives but they would become unsound the moment they ceased to regard them.

A much keener and truer view of the importance of the human motives is taken by another writer, referring to the reorganization of a small, unfinished, unprofitabe but strategically important road. "The Kansas City, Mexico and Orient reorganization at the present time will doubtless be influenced by committee members either seeking to get control for the Southern Pacific, or contrariwise, holding in comtemplation the continuance of an independent property affording connections into the southwest for all those roads from the northeast which would otherwise be bottled up at Kansas City. In such manner does railroad strategy enter into the deliberations of what might otherwise seem to be purely financial bodies." Ripley, W. Z., Railroads, Finance and Organization, 390 (1915).

The third set of controlling motives is legal and judicial. Experienced students of legal practice have worked out certain more or less clearly defined lines of orderly procedure. Some of these lines of procedure have been prescribed by the courts, others are merely tolerated by the courts because they facilitate the regular course of the reorganization, and others, arising from the ingenuity of lawyers, are followed until some court decision condemns them. Lawyers are apt to exaggerate their own importance and the significance of their legal machinery in determining the form and details of reorganization procedure, forgetful that a reorganization is primarily an adjustment of human motives and economic conditions, circumscribed, rather than determined by the law.[3] The present orderly, and, on the whole, socially expedient procedure in connection with the reorganization of all corporations, large and small, has been built up from the interplay of these three underlying motives.[4]

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[3] As stated elsewhere in connection with railroad reorganization, but equally pertinent to the reorganization procedure of all corporations, "One may hazard the guess that there is no field of modern economic relations where legal phrases count for as little as in railroad reorganization; and as time passes their significance seems to become less." Dewing, A. S., 6 Am. Ec. Rev., 907 (1916). Or again, "Railway mortgages are not sacred because of the strong legal terms in which they are drawn, but are dependent on success in the business of transportation. . . . Our practice of railway receivership is thus a development of our own circumstances and a sort of compromise between the too strong language of our mortgages and the actual conditions of the business of transportation." Greene, T. L., "The Commercial Basis for Railway Receivership," 33 Am. Law Reg. and Rev., 417 (1894). The earliest clear acknowledgment by the judiciary itself of this fact, that the author can find, is a statement by Chief Justice Waite some thirty-five years ago: "It rarely happens in the United States that foreclosures of railway mortgages are anything else than the machinery by which arrangements between creditors and other parties in interest are carried into effect." Can. So. Ry. v. Gebhard, 109 U. S. 527 (1883). It is noteworthy that this admission that legal steps constitute the "machinery" for accomplishing economic ends, is quoted with approval by Cravath in his essay on the legal procedure (note 19). On the other hand, the majority of lawyers and judges would give the impression that legal procedure embraces about all there is to a reorganization.

[4] In addition the reorganization procedure and particularly the reorganization plan of a railroad or other public utility must now meet the approval of the railroad, public service, or other commission. In many states specific statutes require that reorganization must receive the approval of the regularly constituted commission having jurisdiction over the particular kind of enterprise being reorganized. An elaborate discussion, with exhaustive citations, of the jurisdiction of a public service commission over a railroad reorganization is given in Opinion and Order, 815 (Dec. 22, 1915) Mo. Pub. Serv. Com. (Re St. Louis and San Francisco reorganization plan of Nov. 1, 1915).

The New York statute (Laws 1912, Chap. 298, Sec. 55a) specifically provides: "1. Reorganization of railroad corporations, street railroad corporations and common carriers pursuant to sections nine and ten of the stock corporation law and such other laws as may be enacted from time to time shall be subject to the

The explicit failure of an industrial company may come suddenly, as the immediate consequence of a labor strike, a panic, or a bank failure, or even the death of an important director. A railroad failure, or the failure of a local utility, invariably due to deep-seated, slow-acting causes, may often be postponed or quickened at the discretion of those in immediate control. At all events, when the financial and operating conditions of the corporation reach such a pass that a crisis seems inevitable to the management, it takes one or both of two steps—the organization of protective committees and the petition for the appointment of a receiver. Sometimes committees close to the management are formed before failure has reached a critical stage, one of the avowed purposes being to prevent or forestall receivership proceedings;[5] and sometimes receivership proceedings are brought suddenly, and almost at the last moment, before the management has an opportunity to organize a "stockholders' committee."[6] Thus

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supervision and control of the proper Commission and no such reorganization shall be had without the authorization of such Commission.

"2. Upon all such reorganizations the amount of capitalization, including therein all stocks and bonds and other evidence of indebtedness, shall be such as is authorized by the Commission which, in making its determination, shall not exceed the fair value of the property involved, taking into consideration its original cost of construction, duplication cost, present condition, earning power at reasonable rates and all other relevant matters and any additional sum or sums as shall be actually paid in cash, provided, however, that the Commission may make due allowance for discount of bonds. Any reorganization agreement before it becomes effective shall be amended so that the amount of capitalization shall conform to the amount authorized by the Commission."

It is of interest to note that the statute of the state of Missouri, under which the Public Service Commission assumed jurisdiction over the Missouri Pacific and St. Louis and San Francisco reorganizations, employs the identical words, just quoted from the New York statutes adding: "The Commission may by its order impose such condition or conditions as it may deem reasonable and necessary." (Sec. 62.)

[5] This is true for all corporations, especially when the decline in the corporation's credit has been gradual, obvious to all, and due, probably, to deep-seated and far-reaching causes. Thus the credit and the financial standing among investors of the Missouri Pacific Railway had fallen steadily since 1900. This was apparent to all. The conditions grew worse, year by year. Finally in July, 1914, protective committees were organized in the hope of effecting a "readjustment" (an innocuous word substituted for reorganization). The petition for receivership was not made until August, 1915, when it was found that the various committees could not accomplish this "readjustment."

[6] These sudden and unpredicted crises, at which there is insufficient time to organize protective committees, are commonest in the industrial field. The receivership of the old National Cordage Company in 1893 occurred suddenly after a day of precipitous decline in the company's securities. The receivership of the Westinghouse Electric and Manufacturing Company at the climax of the panic of 1907 occurred suddenly at the request of large outside banking interests. In such cases there is no time to organize committees of any sort, although frequently the

no general rule can be laid down covering the order of these two events, but the public acknowledgment of financial failure is indicated if one or the other or both of them occur.

The organization of protective committees is more important than the receivership proceedings, the latter being a legal formality now often dispensed with. The committees arise from two different sources—the stockholders and the creditors. Invariably there is at least one stockholders' committee, usually dominated by the old directors of the corporation. This committee acts on the defensive; throughout the whole course of the reorganization proceedings the stockholders' committee is engaged in explaining and justifying the past management, and haggling with the other committees in regard to the extent of the sacrifices which the old stockholders must undergo in order to regain the control of the corporation. The other types of committees are representative of different classes of creditors. In the reorganization of a small industrial corporation, there is, in addition to the stockholders' committee, only one committee of creditors. In intricate industrial reorganizations there may be separate committees representing the merchandise creditors, the bank creditors, and the public holders of the notes and debentures. In intricate railway reorganizations there may be committees of junior bondholders, of the senior bondholders, of branch and divisional line bondholders, and of the bondholders of subsidiary lines or terminal properties controlled through leases or operating contracts. The committees of the holders of the floating debt are usually formed and dominated by the large bank creditors. The committees of bondholders are formed and dominated by the investment banking houses which were responsible for the original sale of the bonds to the public; if the bonds were distributed long ago, prominent

executive committee of the corporation or a group of the directors constitute themselves a stockholders' committee.

trust companies or life insurance companies may assume the guiding hand.[7]

The committee or committees representing the floating debt, the junior bonds, the notes and debentures, will stand antagonistic to the committee of stockholders. They will insist that the junior creditors shall endure as little sacrifice as possible, and that the full brunt of the burden of reorganization shall fall on the stockholders. The committees of senior bondholders will assume throughout an attitude of watchful waiting. In the majority of cases, especially if the property is a railroad and the lines covered by these liens are strategically important for the unity of the railway system, these committees will be called upon to take little part in the reorganization. If, as is the case in comprehensive railroad reorganizations, they are required to fund their bonds under new first and general mortgages, they will be able to prescribe the conditions which the junior bondholders and stockholders must accept.

In the older reorganizations, there were more committees than at the present time.[8] The tendency now is to have few committees but to have these few representative and responsible and to endow them with considerable power.[9] It facilitates matters very much if the important committees agree

[7] In rare instances there are special committees representing special interests. For example, in the last reorganization of the Westinghouse Electric and Manufacturing Company an employees' committee was organized. In the older railroad reorganizations of the middle nineties it was usual to have "foreign bondholders'" committees.

[8] For example, before the Union Pacific reorganization had been accomplished, no less than fifteen committees had been formed. There were committees representing the first mortgage bonds, the consolidated mortgage bonds, the collateral trust 5's, the collateral trust 4½'s, the Oregon Railway and Navigation consolidated bonds, the Dutch bondholders, two committees each for the Kansas Pacific consolidated bonds and the Denver extension bonds, a joint committee of foreign bondholders, and various committees representing branch line bonds. Daggett, S., Railroad Reorganization, Chap. VII (1908).

[9] On the whole the following practice is becoming clear: The various classes of holders of debts and securities organize themselves into as many committees as there are substantial equitable interests in the corporation, but no more. A duplication of committees, representing the same interest and differing only in personnel, is frowned on by the courts and acts merely as a brake on the course of the reorganization. The effectiveness and responsibility of committees will vary directly as the authority vested in them.

among themselves upon the formation of a general reorganization committee upon which representatives of the different committees serve. Not only does such a general committee tend to ease the tension and remove misunderstandings, but it makes possible a unified and far-sighted policy of investigation during the period immediately following the failure, and it does away with unnecessary public discussion and wrangling over successive plans of reorganization. Such a general committee assumes the burden of preparing a plan of reorganization in the interest, ostensibly at least, of impartial justice.

While the formation of committees is entirely a matter of invitation and mutual agreement, there are very distinct responsibilities attached to membership on important reorganization committees. Formerly membership was more or less a matter of accident, or at most a privilege attaching itself to the ownership of a considerable block of securities the value of which had been placed in jeopardy by the financial crisis. In consequence, important committees were often made up of men of little intelligence or familiarity with finance, quite generally they had no standing beyond their own cities. At the present time, however, the custom is to have well-known, highly responsible men serve on the various reorganization committees; men are chosen more because of their national reputation in banking circles, their acknowledged integrity, proved wisdom, and financial experience, than because they own or control a considerable amount of securities. And such a mode of selection is wise. Large and important corporate reorganizations require highly expert and specialized knowledge. The greater the number of reorganization committees a man has served upon, the greater is his value, and after a time he acquires a kind of national reputation for skill in this particular field. He will not acquiesce in the acceptance of a reorganization plan likely to jeopardize his reputation for honesty and impartiality. Moreover, the

plan of reorganization finally agreed upon by men of acknowledged responsibility and expertness will receive public approval much more readily than a plan advanced by men of little prominence. This general tendency to have the reorganization of important corporations supervised by highly responsible experts, rather than by holders of large amounts of securities, is in general accord with the tacit acknowledgment that such reorganizations are matters of public concern.[10]

As soon as each committee is formed, it organizes itself, selecting one member to act as chairman.[11] A legal counsel is chosen by the committee and some trust company is asked to receive the deposit of securities under a general agreement according to the terms of which the committee is empowered by those depositing their securities to act for them and in their stead. The powers conferred on the committee by this deposit agreement are very general, and the tendency of recent years is to enlarge them. In fact, it may be said that the committees are trustees for the depositors under their agreement, acting with all the powers possessed by the owners separately and with the additional powers that their majority control involves.[12]

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[10] From the above account, it should not be inferred that reorganization committees "constitute themselves," as it were, out of a clear sky. Ordinarily some banking house has been the acknowledged sponsor for the corporation owing to the sale of large blocks of bonds. This banking house will "invite" prominent bankers to become members, thinking by so doing to give added respectability to their committee. The directors, similarly, will "invite" other prominent bankers to serve on their stockholders' committee.

[11] Great care must be taken that the committee members, particularly the chairman, shall be free from partiality, else the court may permit a duplication of committees, thus impeding the reorganization. In the recent reorganization of the Chicago, Rock Island and Pacific Railway, the president of the trust company, which was trustee of the bonds upon which the foreclosure suit was based, was chairman of the bondholders' committee. The court considered this a dual position, and permitted a minority bondholders' committee to intervene, thus creating unfortunate complications. Central Trust Co. v. C. R. I. & P. R. R. Co., 218 Fed. 336 (1914).

[12] The legal powers of reorganization committees acting under modern deposit agreements have been briefly summarized by the late Adrian H. Joline, one of the ablest masters of the procedure of reorganization.

"There is conferred upon the Committee all the rights and powers of owners of the deposited securities and full discretion as to the methods of carrying out the agreement, with power to construe it.

"The Committee is usually authorized to maintain necessary suits, to sell the deposited securities under certain restrictions appropriate to the case; to put in motion suits to foreclose mortgages; to purchase the property at any sale, using the deposited securities so far as may be in payment of the purchase price, with

The character and the significance of the legal aspects of a reorganization depend, very largely, on whether or not a receiver is appointed to administer the business during the period between the financial crisis and the final consummation of the reorganization. This, in its turn, depends on whether or not there is likely to be acrimonious and prolonged dispute among the various security holders, and whether or not a recalcitrant group of security holders is likely to try to impede or even to frustrate an amicable settlement of conflicting interests. If the failure is very serious, thus entailing large losses to all concerned, or if it involves a large railway embodying many conflicting interests, or if there are burdensome leases and contracts which must be abrogated at all hazards, then receivership proceedings are necessary. A drastic, but fair, reorganization can be carried through in an autocratic manner if a receivership is resorted to, because in the end, by a judicial sale of the bankrupt corporation's property, the court can force a recalcitrant minority to accept what it considers a just reorganization plan or extinguish the interests of the minority. But if the reorganization is that of a small industrial corporation, the opposing parties of which are two or more closely knit factions who are able to compose their differences, or if the crisis is merely temporary so that little permanent sacrifice is required of anybody, then the various security holders can probably arrange a plan of reorganization among themselves, without resort to the machinery of the courts. A reorganization consummated without compulsory

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power to borrow money necessary to complete the payment and to assign the bid or otherwise use the property to secure repayment of the sums borrowed; and to convey the property to a new company or otherwise dispose of it subject to the conditions set forth in the agreement.

"The Committee generally has power granted to it to limit the time for making deposits; to employ counsel and assistants; to receive reasonable compensation, sometimes limited to a certain percentage on the face value of the deposited securities, and to have its expenses paid subject usually to a like limitation. The Committee is frequently authorized to borrow money and to pledge the deposited securities as collateral for the loan, for the purposes of the agreement, the protection of the depositors, the preservation of the property, or to defray expenses.

"Depositors incur no personal liability for expenses, but the deposited securities constitute the fund for that purpose." Joline, A. H., Lectures, Graduate School of Business Administration, Harvard University, Notes 12

pressure exerted by the courts through judicial sale, even though a receiver be appointed at some stage in the proceedings, is called *voluntary*;[13] one consummated through the coercive authority of the courts, represented by a judicial sale of the property of the old corporation and the organization of a new corporation, is called *involuntary*.[14] The vast majority of railroad reorganizations are involuntary, and follow a court receivership, although from time to time voluntary reorganizations have been attempted for large railway systems, and sometimes they have been successfully consummated.[15] There have

[13] The word by no means implies that the security holders enter into the reorganization willingly and of their own choice. It is, in truth, voluntary only in the sense of offering the various security holders more liberal terms than if the financial embarrassment was settled through a foreclosure sale under the supervision and compulsion of the courts. "The readjustment plan," said an editorial writer, speaking of the Missouri Pacific plan of July, 1915, "is said to be called voluntary because the security holders have the option of accepting its terms or of waiting for a more drastic plan." 6 New York Times Annalist, 36 (July 12, 1915).

[14] There is possible a kind of threefold classification depending on legal sanctions:

1. Voluntary, without receivership: when failure is due to temporary causes, that operate relatively slowly, or to the difficulties that are easily adjusted by the security holders. This type is common among industrials, local public utilities, and small railroads. It is rare for large railway systems. The Atchison reorganization of 1889 is one of the rare cases of a voluntary thoroughgoing reorganization of a large railway system consummated without receivership.

2. Voluntary, with receivership: when failure is due to temporary causes, operating quickly, or when valuable property with large equities meets sudden disaster. This type is very common among industrials of all classes. It is the usual form of voluntary reorganization among railroads. The Baltimore and Ohio reorganization of 1899 is an illustration.

3. Involuntary, with receivership: the ordinary form. Almost universal among railroads and commonest among industrials and local public utilities. (See note 18.)

[15] In the summer of 1915 a voluntary reorganization, without receivership, was attempted for the Missouri Pacific Railway. As a voluntary reorganization it was unprecedented in the history of railroad finance for the radical sacrifices demanded of the branch line and junior bondholders. To accomplish the co-operation of these bondholders and of the assessed stockholders, the committees pointed out that a receivership, entailing much added expense, would be necessary unless the security holders consented. They refused. A receivership followed, and under the authority of the courts the identical plan of reorganization was forced upon the security holders at greatly increased expense to the corporation.

The reorganization of the Baltimore and Ohio Railroad in 1899 was finally consummated without a foreclosure sale of the main railway system. This is true notwithstanding the fact that considerable sacrifice was imposed on all the security holders, and even the owners of old, underlying prior lien bonds were asked to exchange them for new general mortgage bonds. All things considered it was probably the most remarkable case of the voluntary reorganization of a great railway system to be found anywhere in the annals of American finance. It succeeded, because the wave of industrial prosperity observable everywhere since 1897 and particularly conspicuous in the railway industry, made all concerned anxious to get the securities offered them in the reorganization plan, and therefore impatient at all delays. Numerous references to this reorganization will be found in Chapter VI. The entire plan may be studied with profit. It is reproduced at length in Gerstenberg, C. W., Materials of Corporation Finance, 966 (1915).

Voluntary reorganizations have been very frequent among industrials. Here there are usually fewer types of securities to be considered, fewer divergent interests to be placated, and the necessity of bringing the period of financial distress to a close can be stated more forcibly than in the case of railroads. A railroad or local public utility may carry on its business under a receiver quite as economically

been many voluntary reorganizations of large and small industrial and local public utility corporations.

The paramount advantage of a voluntary reorganization is that it preserves valuable rights. The whole reorganization can be carried out with little outward formality and without harming the general credit of the corporation or any "good-will" values belonging to its trade-marks or franchises.[16] The objections to such a reorganization lie entirely in the difficulty of its execution and in the large amount of securities which

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and acceptably to the public as under its corporate owners. In fact there have been instances of honest receivers managing a railroad much better than it was managed by narrow-visioned or irresponsible directors. The old Buffalo and Susquehanna Railroad Company was managed much better by its receiver than by the old directors who were mainly interested in the weak-kneed Buffalo and Susquehanna Railway Company. See Chapter VI, note 39. But an industrial, except in very rare instances, is not managed well by its receiver. Long-time contracts for merchandise must be entered into, selling campaigns must be planned, the personnel of the organization stimulated in zeal and constantly improved, buyers must be inspired with confidence, and banking credit strengthened. All these things a receiver, holding his position only for a temporary period, cannot do. For this reason, if for no other, the various factions will compose their differences as quickly as possible in order that the corporation may quickly resume its normal business activities.

[16] The advantages of a voluntary reorganization of a railroad over one following a foreclosure and termination of the old railroad corporation, aside from the greater economy, lie chiefly in the preservation of the intangible values of the old charter. Ordinarily, the original railroad was incorporated years before, when railroads were given more liberal charters and before restrictive legislation had curtailed their corporate powers. The case of the Philadelphia and Reading has been cited many times to illustrate this principle. The road was given, in 1833, a remarkably liberal charter by the Legislature of Pennsylvania. Beginning in 1869 the road began to acquire coal lands in its own name, an act not expressly forbidden by its charter nor any subsequent state statute. But in 1874 a new constitution came into force in the Commonwealth of Pennsylvania which expressly forbade railroads to own and operate coal properties. Subsequently the Reading failed twice and was twice reorganized—in 1882 and 1888—but at neither time was there a foreclosure sale. So that, in spite of its long series of vicissitudes, the Reading was still operating under its original charter of 1833 when it passed into receivers' hands for a third time in February, 1893. The chief reason which had led to the two voluntary reorganizations of 1882 and 1888 was the fear that the reorganized company would be unable to secure a charter enabling it to hold coal lands. Because of this fear, the plans of both of these reorganizations treated the security holders so liberally that the reorganizations benefited the road but little. Thus in the reorganization of 1882 the fixed charges were actually increased from $7,700,000 to $11,000,000 a year, an increase of 49 per cent. In that of 1888 the fixed charges were reduced slightly, less than 8 per cent, whereas the average reduction in fixed charges for involuntary reorganizations is much greater.

In many instances an old and liberal charter, or merely a specially useful provision of one, has been considered so valuable that it has appeared cheaper in the end to pay off a recalcitrant group of minority security holders than to eliminate them through a foreclosure sale involving the forfeiture of the charter. Numerous instances are cited by Cleveland and Powell, Railroad Finance, 248 (1912). For example, the Fort Worth and Denver City, and the International and Great Northern, two roads traversing Texas, were reorganized without foreclosure in the middle nineties because their original charters protected them against certain laws of Texas regarded as burdensome. 54 Chron. 366; 62 Chron. 40. "The affairs of the Wisconsin Central were readjusted without foreclosure in 1879, because the tax exemption on its land grant could not be transferred to another company." Cleveland and Powell, Railroad Finance, 249 (1912). See also note 71 of present chapter. Also observe the text and accompanying notes on page 159.

must be issued in order to please everybody concerned. In several large and important reorganizations of this kind it has been found expedient to carry on parts of the reorganization under the protection of the court.[17] The number of these voluntary reorganizations, aside from minor capital readjustments, has been relatively small.[18] And in all respects, except in certain details of legal procedure, voluntary reorganizations are similar to those consummated through foreclosure sale. The subject of voluntary reorganizations is briefly discussed again in the closing section of the chapter dealing with the reduction of fixed charges in current reorganizations. (Chapter VI.)

In the vast majority of cases, the first step in the legal procedure of the reorganization is the appointment of a receiver by a court of equity.[19] It cannot, however, be stated

[17] In a voluntary railroad reorganization, where there exists a large variety of subsidiary roads and underlying liens, it is usually necessary for the reorganization committee to institute foreclosure suits on some of these subordinate lines. In the notable case of the Baltimore and Ohio reorganization of 1899, it was necessary to foreclose the mortgage held on a dozen branch and subsidiary lines although there was no foreclosure on the mortgages involving the main system as a whole, and no judicial sale of the whole property, in spite of the variety of conflicting liens. (See note 15.)

[18] In the case of railway reorganizations certain statistics are available to show the relative frequency of voluntary reorganizations. Thus in Meany's list of 313 reorganizations completed between 1884 and 1900, only 16 were accomplished without foreclosure. Poor's Manual of Railroads, 1900, Introduction. Including the second Reading and the first Atchison reorganization not included in this computation, approximately half of these 18 occurred before 1893, whereas in the general list of involuntary reorganizations something less than a third occurred before 1893. Poor's Manual of Railroads, Introduction (1900). This conclusion is borne out by Daggett, who finds that of nine of his reorganizations occurring prior to 1890, five were consummated without foreclosure; whereas of the six consummated between 1894 and 1899, one only, the Baltimore and Ohio, was carried out without foreclosure. Daggett, S., Railroad Reorganization, 335 (1908). Since 1900 it would seem that the relative proportion of voluntary reorganizations has been on the increase, so that the relative proportion of voluntary reorganization was least from 1893 to 1900. This is to be expected because during the business depression following the panic of 1893 the earnings of the roads were at a low ebb, and therefore least likely to encourage voluntary sacrifices on the part of their security holders.

[19] The appointment of a receiver to conserve property is one of the so-called "extraordinary remedies" allotted by our Anglo-Saxon law to the equity courts. Such courts "will not lend their aid by the appointment of receivers when the persons seeking the relief have ample redress by the usual course of proceedings at law, or when the law affords any other safe or expedient remedy." High, J. L., A Treatise on the Law of Receivers, 16.

"The court of equity can exercise its discretion as to whether it will appoint the receiver." Mil. & Min. R. R. Co. v. Soutter, 2 Wall. 510 (1864). Also 8 Biss. 247.

The position of a receiver is very concisely described: "By means of the appointment of a receiver, a court of equity takes possession of the property which is the

that all receivership proceedings arise from anticipated or actual failure.[20] Historically the current procedure has

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subject of the suit, preserves it from waste or destruction, secures and collects the proceeds or profits, and ultimately disposes of them according to the rights and priorities of those entitled. . . . The receiver appointed is the officer and representative of the court, subject to its order, accountable in such manner and to such persons as the court may direct, and having in his character of receiver no personal interest but that arising out of his responsibility for the correct and faithful discharge of his duties." Beverly v. Brooke, 4 Grat. 187.

The duties of receivers for public service corporations are briefly described by Judge Lacombe: "Their (the receivers') sole functions are to hold the property intact, operating it as efficiently for the public service as their resources will permit, to ascertain the liabilities, to marshal the assets and eventually . . . to sell it to the best advantage and to apply the proceeds ratably to the payment of the liabilities." Penn. Steel Co. v. N. Y. C. Ry. Co., 157 Fed. 440 (1907).

For brief and comprehensive accounts of the appointment and duties of receivers, see the two essays by Byrne, J., and Cravath, P. D., Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation (1917), being addresses delivered in 1916 at the instance of the Association of the Bar of the City of New York by distinguished practicing lawyers. These two essays, together with the lectures by the late Adrian H. Joline in 1909 at Harvard, are the best available brief summaries of legal procedure of a modern corporate reorganization.

There have been a large number of periodical articles dealing with railroad receiverships: Caldwell, H. C., "Railroad Receiverships in Federal Courts," 30 Am. Law Rev., 161 (1895); Bennett, A. S., "Railroad Receiverships," 6 Oregon Bar Assn. Pro., 47 (1886); Crowell, J. F., "Railway Receiverships in the United States," 7 Yale Rev., 319 (1898); Swain, H. H., "Economic Aspects of Railroad Receiverships," 3 Economic Studies, 53 (Am. Ec. Assn., 1898); Daggett, S., "A Study of Railroad Receivership," 37 Ry. Gaz. 206 (1904); Daggett, S., "Recent Railroad Failures and Reorganizations," 32 Q. J. E. 446 (May, 1918). Special articles will be referred to under special topics.

For the more general works see Alderson, W. A., A Practical Treatise on the Law of Receivers; High, J. L., A Treatise on the Law of Receivers; Jones, S. W., A Treatise on the Law of Insolvent and Failing Corporations.

[20] In the first place, especially of recent years, receivership proceedings have been instituted or threatened by state or federal officers for alleged violation of the Sherman Anti-Trust Act of 1890.

The number of receiverships resulting from dissensions, disputes, and intercorporate intrigues is legion. It was alleged that the Cincinnati and Eastern Railway went into the hands of receivers as part of the consummation of a plan to secure the road for less than its value. 8 Ry. Age, 596. See also F. L. T. Co. v. N. Y. & Nor. Ry. Co., 150 N. Y. 410 (1896). Some stockholders of the Ohio and Mississippi Railroad declared that its collapse and receivership in 1876 was part of a concerted plan on the part of the Baltimore and Ohio Railroad to secure control. 14 Chi. Ry. Rev., 29; 16 Chron. 392; 22 Chron. 526. Probably the real cause was the excessive and unwarranted cost of building the Louisville branch. Receivers were appointed for the Cincinnati, New Orleans and Pacific Railway in 1893 in order to protect the road from liability for stock fraudulently issued by a former secretary. Hollander, J. H., "The Cincinnati Southern," 12 Johns Hopkins Univ. Studies, 1 (1894). In 1904 the Eastern Ohio Traction Company went into the hands of receivers because of the fear of damage suits resulting from a wreck on the Chagrin Falls branch. Receivers have been appointed in several cases because of controversies over leases as in the case of the Eastern Railroad of New Hampshire in 1877, and the Denver and Rio Grande in 1879. The old Indianapolis, Bloomington and Western Railroad had leased the Cincinnati, Sandusky and Cleveland. A controversy arose and the former road was placed in the hands of receivers in order that the controversy might be settled. 43 Chron., 515. Instances also exist where a receiver has been appointed to settle controversies existing between opposing interests. The St. Louis, Vandalia and Terre Haute was controlled for many years in the interest of the Pennsylvania company. The minority stockholders of the former objected to the use made of the apparent net earnings and a receiver was appointed in 1902 to settle the controversy.

Swain gives instructive instances among early receiverships of exceptions to the rule that failure is the universal condition of receivership. The Cleveland, Delphos and St. Louis Railroad was placed in the hands of receivers in 1884 and the Tennessee Central in 1895 in order to complete construction. The directors sought receivership for the Hutchinson and Southern in 1893 to transfer control

developed by a slow evolution. It represents the gradual transition from a complex, haphazard procedure to enforce railway obligations, current fifty years ago, to the relatively simple and orderly procedure of the present time.

In the earlier years, roughly, before the panic of 1873, corporate mortgages were construed literally. In case of a default in bond interest the trustee of the mortgage might acquire possession and management of the railway property, as the strict construction of the mortgage instrument permitted,[21] or a receiver might be appointed at the instance of an antagonistic creditor.[22] The details of the procedure were

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from a county to a federal court. Swain, H. H., "Economic Aspects of Railroad Receiverships," 3 Economic Studies, 90, 94 (Am. Ec. Assn. [1898]).

In more recent corporate history, the Kansas Natural Gas Company was thrown into the hands of federal court receivers in 1912 to protect the company from what was regarded as the unlawful demands by state and municipal authorities, the federal court being considered able to prevent the sale of gas at less than cost. In 1911 the La Crosse Water Power Company was placed in receivers' hands to protect the company from damage suits caused by inability of the company to deliver current contracted for, on account of low water and the breaking of dykes.

[21] On default, the bondholder or his trustee waited during the period of grace, from thirty days to six months or even longer, and then began a foreclosure suit. In the absence of a receiver, the trustee of the bonds would assume the management of the railway. Notable case, Hartford, Providence and Fishkill Railroad, 22 Chron. 304. The old Hartford and Connecticut Valley, in financial straits, was operated from July, 1876, to January, 1878, by the trustee of the Second Mortgage Bonds, and from January, 1878, to July, 1880, by the trustee of the First Mortgage bondholders. In rare instances, such action has actually been preferred by the court to the appointment of a receiver on the ground that less harm would be done to all the parties concerned. Tysen v. Wabash R. R., 8 Biss. 247. But, owing to the variety of mortgages and the divergence of interests, this mode of procedure has been found to be cumbersome and prolific of disputes. Furthermore, with the growing consciousness that railroads were public enterprises, the courts were at first reluctant and later refused to extend to the mortgage trustees the full power the letter of their mortgage instruments implied, so that the trustees found their management hampered.

A transitional form, between trustee management and court management of an embarrassed corporation is the management of some public officers. It was rare, but occurred, nevertheless, especially in New England. Thus the Connecticut Central Railroad was surrendered to the State Treasurer of Connecticut in April, 1880. A similar disposition was made of the Hartford and Connecticut Western Railroad.

Crowell calls the transition from trustee management to receivership in cases of financial distress "the history of the evolution of responsible management in an entirely new species of corporate enterprise, involving a unique complex of interests individual and social." Crowell, J. F., "Railway Receiverships," 7 Yale Rev., 330 (1898). For brief discussions of trustee management and the difficulties involved, see Barrett, C., "Dangers to Bondholders," etc., 11 Ry. Gaz., 385 (1879); Crowell, J. F., "Railway Receiverships in the United States," 7 Yale Rev., 327 (1898); Cleveland and Powell, Railroad Finance, 230 (1912); Ripley, W. Z., Railroads, Finance and Organization, 384 (1915).

[22] In these early railroad receiverships, there was invariably an actual, not merely fictitious, opposition between the parties praying for the appointment of a receiver and the answer by the railroad's attorneys. The action was then, as now, usually initiated by a creditor's bill, claiming that the means for satisfying the creditor's claim was in jeopardy. This action by a creditor might or might not be a part of a contemporaneous action by a mortgage trustee seeking to assume the control and operation of the railway property. At all events, an officer of the corporation

distinctly matters of accident, the only certain thing being a variety of suits and countersuits, all based on the desire of some faction to gain a temporary advantage through legal process.

The first period ended, and what we might call the second period of receivership procedure began, with the failure of the Wabash Railway in 1884.[23] This important failure and the resulting reorganization were epoch-making in many respects, but in none more than in the procedure by which it passed into the hands of the court. It was well known at the time that the Wabash system was unstable financially, but there had been no specific failure to meet any of its obligations. Yet just before the inevitable default on one of its thirty-odd mortgages, the officials of the road appeared before a federal court, and asked, on the petition of the road itself, that receivers be appointed. "If the lines," the petition reads, "of the road are broken up and the fragments thereof placed in the hands of various receivers, and the rolling stock, materials, and supplies seized and scattered abroad, the result would be irreparable injury and damage to all persons having any interest in said line of road." The petition was granted. A corporation had placed itself in the hands of receivers.

The procedure in connection with the receivership of the Wabash Railway was heralded by all students of law as revolutionary and establishing a new interpretation of the theory of receiverships. Yet the action of the federal judge was fully

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ordinarily appeared in honest opposition to the proceedings, and, as a result of the evidence presented by both sides, the court obtained some inkling of the truth.

[23] The details of this particular reorganization are given in summary form in a brief outline of the history of the theory of railroad reorganizations. (See Chapter IV, page 77).

Crowell believes that the modern doctrine of railway receivership proceedings—in which the railroad itself may be an active or passive participant in placing itself under the administration of the court—"received its earliest formulation in the South." He cites as a leading case Meyer v. Johnston, 53 Ala. 237 (1975). This case contains an elaborate discussion of the rights of a court of equity in appointing receivers at the request of stockholders. See also 18 Grattan 819. Unquestionably the principle had been tacitly admitted in certain courts before its explicit acknowledgment in the Wabash case. See also Jones, L. A., "Receivers of Railways," 4 Southern Law Rev., 18 (1878).

sustained by the United States Supreme Court.[24] And occurring as this did, in the period just before the many railway receiverships of the nineties, the Wabash receivership established the practice of the so-called "friendly" or consent receiverships for large railway corporations; and the procedure was soon applied to local utilities[25] and later to indus-

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[24] Wabash, St. Louis & Pac. Ry. Co. v. Central Trust Co., 22 Fed. 138 (1884); Quincy, Miss. & Pac. R. R. v. Humphreys, 145 U. S. 82 (1892); St. Joseph & St. Louis R. R. v. Humphreys, 145 U. S. 105 (1892).

At that time the whole Wabash system consisted of over fifty subsidiary parts; it extended into six states. The federal justice who made the revolutionary decision saw fit later to defend his action as follows: "It was an application by the corporation itself, concerning which a great deal of comment has been made elsewhere. . . . I hesitated. I found that Judge Shipman, a very learned and able judge, had gone over *in extenso* that class of thought. After further consideration with respect thereto, I reached the conclusion that his views were correct, to wit: Here is a vast system, extending through many states and many judicial districts. A default, it was certain, would be made in a few days. What should be done? The interests of all concerned required that some judicial action should be had for the conservation of those interests—stockholders, bondholders, creditors at large." 29 Fed. 618, 623 (1886).

Chief Justice Fuller himself quotes the words of one of the attorneys that the bill was "without precedent" (145 U. S. 82, 95), yet approved the principle on the ground of public policy. "We have seen," he said, "that the theory of this bill was that an insolvent railroad corporation may, in the public interest, and for the benefit of all its various creditors, surrender its property to a court of equity, to be preserved and kept in operation until it may be disposed of according to the several private rights concerned." St. Joseph & St. Louis R.R. Co., v. Humphreys, 145 U. S. 105, 113 (1802).

Notwithstanding, however, the explicit approval by the United States Supreme Court, the doctrine was condemned by various state courts on the previously acknowledged presumption that the petition for the appointment of a receiver must represent an "actual controversy." Such a petition (as in the Wabash case), said the Missouri Supreme Court, "is simply a petition by a debtor for the appointment of a receiver to manage and carry on its business, so that its creditors cannot enforce their legal rights in the courts of the country. . . . The filing of that petition no more instituted an actual controversy between contending suitors than would the filing of the Lord's Prayer. It laid no foundation whatever for the exercise of the jurisdiction of the court to appoint a receiver." State re Merriam v. Ross, 122 Mo. 435 (1894). Nevertheless, these outcries on the part of state courts have availed little, and receivership petitions, instituted directly or indirectly by large public service corporations, have been sustained uniformly by the United States Supreme Court. The whole subject has received extended treatment in an opinion which promises to become a leading case on the subject. Re Metropolitan Railway Receivership, 208 U. S. 90 (1908).

The significance of the Wabash case has warranted extended discussion. Besides the cases cited in this note, see 38 Chron., 639; "A Chapter of Wabash," 146 North Am. Rev., 178 (1888); "The Wabash Receivership Case," 21 Am. Law Rev., 141 (1887). Also comments in Cleveland and Powell, Railroad Finance, 235 (1912); Ripley, W. Z., Railroads, Finance and Organization, 385 (1915). See also note 27 concerning friendly receiverships.

[25] Interesting case, Farmers' Loan & Tr. Co. v. Meridian Water Co., 139 Fed. 661 (1905). Judge Lacombe succinctly summarized the situation in an important opinion. "Under authority conferred by the State and by various local authorities they are principally engaged in the means whereby streets, avenues and public places in the State are lighted and the public safety and comfort thereby promoted. They are corporations of public utility, and if they did not themselves light these localities the public authorities would, no doubt, be constrained to do so themselves. By reason, moreover, of the circumstance that they are given the authority with—to a certain extent—the right of exercising eminent domain, they are correlatively charged with a duty to the public which is no part of the obligations of ordinary corporations engaged in manufacturing, trading, printing, publishing, mining or mercantile pursuits. And as a result, when financial adversity overtakes them, there are interests which have to be considered other than those which require

trials.[26] These consent receiverships are the rule for all large corporate failures.[27] Brushing aside exceptional conditions,

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attention when these ordinary corporations of the enumerated classes become insolvent.

"In the case of a public utility corporation, such as these, the public itself, the community in which the corporation is rendering service, has a right superior even to creditors of every class, and which right cannot be extinguished by the payment of a dividend in money. Moreover, the public safety and comfort imperatively demand that, whatever else may happen, the corporation, devoid of ready cash though it be, shall not make default on the public obligations with the result of plunging the community in darkness or stopping the transportation of passengers, and that in some way or other, the public service shall be rendered while the financial affairs of the company are being wound up."

[26] Hollins v. Brierfield Coal & Iron Co., 150 U. S. 371 (1893) and Guaranty Trust Co. v. Internat. Steam Pump Co., 231 Fed. 594 (1916).

[27] In the words of the late Adrian H. Joline:

"Apparently well-established principles of law, based on economic and social expediency, enable every company in difficulties, which can find a non-resident creditor, willing to act, to place itself in the possession of a federal court receiver whenever it pleases." Lecture before Graduate School of Business Administration, Harvard University (April 4, 1910).

In many instances minority interests have sought to set aside consent receiverships on the ground of dishonest collusion. For illustration, when the Philadelphia and Reading Railroad had failed in 1893, after riotous speculation by the president, this same president was appointed one of the receivers. The junior bondholders petitioned the court saying the ("friendly") creditor "did not file his bill in good faith on his own behalf and on behalf of all other holders of bonds, but at the request and for the benefit and protection of the men who were then managers of the Philadelphia and Reading Railroad Company and the Philadelphia and Reading Coal and Iron Company, and that the suit was not being pressed with due diligence." 18 Ry. Age, 735.

One of the most barefaced admissions on the part of a railroad management of the prostitution of court procedure to private ends is afforded by a statement to the stockholders of the Eastern Ohio Traction Company (dated February 15, 1904): "The appointment of a receiver is only a friendly arrangement, intended to facilitate plans for reorganization, which when accomplished will increase earning capacity." 78 Chron., 768.

In one or two rare instances the "friendly" receiver appointed on the petition of the corporation itself has been interpreted more as an agent of the corporation, under the protection of the court, than as an officer of the court. "It is but just that a receiver so appointed should be held to be the corporation's agent." Texas & Pac. Ry. Co. v. Gay, 86 Tex. 571. This is probably not good law, as a receiver under whatever conditions appointed "derives his authority from the court and from the parties at whose instance he is appointed. He acts in behalf of no particular interest, but guards the rights of all." 198 Fed. 721, 728. "The utmost effect of his appointment is to put the property from that time into his custody as an officer of the court." 136 U. S. 223, 236; quoted, approvingly, by Chief Justice Fuller, 145 U. S. 82, 97. And the absolute neutrality of the receiver as an agent of the court is justified by a long line of Supreme Court decisions: 14 How. 52; 14 How. 368; 17 How. 322; 136 U. S. 87; 136 U. S. 223; 149 U. S. 473; 208 U. S. 360.

The history of the whole subject of consent receiverships can be followed from a few leading cases: Meyer v. Johnston, 53 Ala. 237 (1875); Wallace v. Loomis, 97 U. S. 146 (1877); Wabash, St. Louis & Pac. Ry. Co. v. Cen. Trust Co., 22 Fed. 138 (1884); Morgan's R. R. & Steam Co. v. Texas Cen. Ry., 137 U. S. 171 (1890); Quincy R. R. v. Humphreys, 145 U. S. 82 (1892); St. Joseph & St. Louis R. R. v. Humphreys, 145 U. S. 105 (1892); Hollins v. Brierfield C. & I. Co., 150 U. S. 371 (1893); Cen. Trust Co. v. McGeorge, 151 U. S. 129 (1894); Compton v. Jessup, 68 Fed. 263 (1895); Continental Trust Co. v. Toledo, St. Louis & K. C. R.R. Co., 82 Fed. 642 (1897); Chapman v. Atlantic Trust Co., 119 Fed. 257 (1902), 145 Fed. 820 (1906), 208 U. S. 360 (1908); Dickerman v. Northern Trust Co., 176 U. S. 181 (1900); Great Western Mining Co. v. Harris, 198 U. S. 561 (1905); Blair v. Chicago, 201 U. S. 400 (1906); Horn v. Pere Marquette Ry. Co., 151 Fed. 626 (1907); Wabash Rd. v. Adelbert College, 208 U. S. 38 (1908); Re Metropolitan Ry. Receivership, 208 U. S. 90 (1908).

The general subject of consent receiverships has been the subject of numerous critical articles: Cohn, M. M., "Railroad Receiverships," 19 Am. Law Rev., 400 (1885); Bartol, W. H., "The Danger of Friendly Receiverships," 32 Popular Science

the usual practice in the consent receiverships may be very briefly stated. The necessity or desirability of a receivership having been agreed upon by the directors (usually in a secret meeting),[28] some friendly general creditor, with a claim in excess of three thousand dollars, not residing in the same state as that in which the corporation has its main office,[29] is asked to allow his name to be used in the receivership proceedings. Accordingly the attorneys for the corporation prepare the necessary bill of complaint to which the creditor complacently signs his name. The attorneys, at the same time, prepare the corporation's answer which admits the allegations of the creditor's bill and prays for the appointment of a receiver.[30] The court grants the prayer and appoints one or more receivers. Subsequently, the trustee of the general junior mortgage brings a foreclosure bill in the court of primary jurisdiction and the same receivers are appointed as under the creditor's bill.[31] At least one receiver is one of

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Monthly, 236 (1887); Woolman, H., "The Bane of Friendly Receiverships," 158 North Am. Rev., 250 (1894); Sterne, S., "Recent Railroad Failures and their Lessons," 17 Forum, 19 (1894); Taft, W. H., "Recent Criticism of the Federal Judiciary," 18 Am. Bar Assn. Rep., 258 (1895); Caldwell, H. C., "Railway Receiverships in Federal Courts," 30 Am. Law Rev., 161; Chamberlain, "New-Fashioned Receiverships," to Harvard Law Rev., 139; editorial, Bradstreet's, Jan., 1894; 1900 I. C. C. Rep., 83.

[28] The receivers for the old New York and New England Railroad were obtained at two o'clock in the morning for fear that attachments would be placed on the company's property the following day. 38 Chron., 30. Receivers for the old National Cordage Company were appointed at ten-thirty o'clock at night, after a day of wild fluctuations in the quoted prices of the company's securities on the New York Stock Exchange. Only in the preceding twenty-four hours had the directors come to realize the serious plight into which the corporation had fallen. The receivership proceedings of the Chicago, Rock Island and Pacific Railway, in April, 1915, came suddenly and as a distinct shock to the business community. The contemplated action was known apparently only to the inner circle of directors, one director going so far as to say that he had been unaware that a receivership was being considered. There had been manipulation of the price of the stock immediately before the receivership, and the price declined abruptly immediately thereafter.

[29] This precaution is necessary in order to bring the action in the federal courts. If it is desired to have the receivership in the state courts, a resident creditor is selected.

[30] This is called the primary bill. Ancillary bills are filed in every judicial district in which the corporation owns property. Early leading case, Booth v. Clark, 17 How. 322 (1854). These ancillary bills must be counterparts, in all important particulars, of the original bill—Merch. Trust Co. v. Kanawha & Ohio Ry., 39 Fed. 337 (1889)—and further state that the court of primary jurisdiction has appointed receivers.

[31] Ordinarily the receivers appointed by the court of primary jurisdiction are respected by other courts, and this court will retain its control to the end of the

the old officials of the corporation, familiar with routine administration,[32] whose name is suggested to the court at the time.[33] The other receiver is a lawyer or publicist in whom the court has explicit confidence.[34]

As soon as the receiver of a corporation has been appointed, he assumes the management of the business. Ordinarily, especially with large corporations such as railroads and traction companies, the receiver makes very few changes in the personnel of his organization, although he may alter entirely the general policy of the corporation in many important respects. For permission to enter into or cancel important contracts, a receiver will usually seek the consent of the court; he must also obtain permission of the court in order to issue receiver's certificates and to expend large sums for the improvement of the property. But in all the details of actual management the receiver is free to follow his own judgment.

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controversy. High, J. L., A Treatise of the Law of Receivers, 73; Muller v. Dows, 94 U. S. 444 (1876). As a result of the tangle over the receiverships following the last failure of the Northern Pacific Railroad, four justices of the Supreme Court declared that the suit should be "commenced in the circuit court of the district in which the principal operating offices are situated and in which there is some material part of the railroad." Farmers' Loan & Tr. Co. v. Nor. Pac. Ry. Co., 72 Fed. 26 (1896). See Daggett, S., Railroad Reorganization, 298 (1908); Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 90, 157 (1917).

[32] The only statistical study of the relative frequency of such appointments, that has come to the writer's attention, is that of Swain regarding railway receiverships. He considers approximately 150 receiverships, from 1867 to 1897. These covered the following appointments: old presidents, 80 cases; general managers, 25 cases; superintendents, 17 cases; vice-presidents, 16 cases. Swain, H. H., "Economic Aspects of Railroad Receiverships," 3 Economic Studies, 53 (Am. Ec. Assn., 1898).

[33] Sterne, an astute student of railroad finance, remarked many years ago: "A railroad official, in consequence of his incapacity or misfortune, or as the victim of a vicious system . . . is appointed receiver by the courts . . . and continues to earn probably a larger salary than he did as president. . . . This evil is a monstrous one." Sterne, S., "Recent Railroad Failures and Their Lessons," 17 Forum, 31 (1894).

Ripley remarked, twenty years later: "The anomaly of rehabilitation entrusted to the very same persons who had brought about the failure is difficult to defend." Ripley, W. Z., Railroads, Finance and Organization, 387 (1915).

In re Metropolitan Railway receivership, 208 U. S. 90 (1908), the Supreme Court sought to absolve the equity courts from any accusation of collusion. But the reasoning hides an obvious fact behind legal verbiage.

[34] Thus in the receivership of the Chicago, Rock Island and Pacific Railway (April, 1915) Judge Carpenter of the Federal Court appointed two receivers. One was H. U. Mudge, former president of the road and an appointee of the Reid-Moore group, who were responsible for the misfortunes of the road; and the other was J. M. Dickinson, a distinguished publicist, in whom the court had justifiable confidence. The decree provided that Mr. Dickinson should have the deciding voice in case of any difference of opinion.

During this period, while the receiver is in actual control of the property of the corporation, the various committees are at work seeking to find a substantial basis upon which to establish their plan of reorganization.[35] This requires a knowledge of at least three sets of facts. First, they must ascertain by competent auditors whether or not the published reports of the corporation in the years preceding the failure were approximately true. The audit must not only verify the technical correctness of the books, but it must also determine whether or not the depreciation accounts were adequate, and if they were not—as was probably the case—the extent of the deficiency. The auditors must also ascertain whether or not all the equipment—machinery, merchandise, or rolling stock—claimed to be in fit, "usable" condition, is actually in use or in fit condition; they must check all the rentals, insurance policies, and intercompany contracts to be sure that the old managers have protected the company's contractual rights. The second set of facts is supplied by attorneys, acting for the reorganization committee. They have to do with the countless legal matters resulting from the general tangle: what contracts may be safely abrogated and what contracts must be fulfilled even at temporary losses, the amounts required to settle with parties holding contingent claims in order to forestall troublesome delays, the probable outcome of pending suits and the approximate expenses of the receivership and reorganization. A third set of facts the reorganization committees must supply themselves, and since there are among their number distinguished bankers, they require no independent expert advice. These facts cover the general probability for the successful negotiation and sale of the securities of the reorganized road. The committees must

[35] It is becoming the custom in large railway reorganizations for the receivers not to concern themselves with plans for reorganization. Penn. Steel Co. v. N. Y. City Ry., 157 Fed. 440 (1907).

assess accurately the probable effect of their reorganization plan on the market values of old and new securities; they must determine the limit of sacrifice stockholders will make without surrendering their interests, the relative marketability of long- and short-term bonds, the expenses and fees of underwriters and similar financial matters.

In the case of a reorganization of a large railway system the reorganization committee must also secure the reports of special traffic accountants working independently or in collaboration with the auditors. They must be able to make a nice determination of the relative and absolute earning capacity of the various parts of the railway system.[36] This is important because only by classifying the subsidiary lines and leased lines according to their past earning capacity can the reorganization committees determine what parts of the railway system to retain in the subsequent reorganization and what parts to surrender.[37] In addition the reorganization committee will probably require of engineers a careful summary of those expenditures which must be made in the immediate future and those which are to be recommended in order to increase materially the future earning capacity of the road.[38]

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[36] See Chapter VI, note 13.

[37] In the earlier reorganizations this classification, if any were made, was more or less a matter of guesswork. In the Wabash reorganization of 1887, all subsidiary parts were retained and approximately equal sacrifices enforced on all the branch line bondholders. In the Atchison reorganization of 1888, there was no attempt to separate the subsidiaries according to earning power. But in the Norfolk and Western reorganization of 1896 and in the voluntary reorganization of the Baltimore and Ohio in 1899 there was a guesswork attempt to apportion the sacrifices of the branch line bondholders according to the probable relative earnings of the branches. In both the St. Louis and San Francisco, and Missouri Pacific reorganizations in 1916 and 1917 efforts were made by the general reorganization committees to determine the actual earning capacity of the subsidiary and branch lines and to apportion the sacrifices accordingly. The committees reached their findings with the help of elaborate reports by engineers, accountants, and traffic experts.

During the receivership of the Bay State Street Railway in 1918, accountants classified the unprofitable branch lines as: (1) those which would pay, provided there was a reasonable increase in fare; (2) those which would pay, provided there was a reasonable increase of fare and substantial subsidies from the local towns; (3) those which would not pay under any reasonable conditions. For the actual working out of this classification, after the consummation of the reorganization of 1919, see a summary article in *The Boston Evening Transcript*, Sept. 24, 1919.

[38] After the appointment of receivers of the Chicago, Rock Island and Pacific Railroad in 1915, several more or less elaborate reports were prepared by engineers. The report of J. W. Kendrick, a distinguished railroad engineer, has become quite a classic because of its thoroughness and comprehensiveness. The following sum-

They may even secure a physical valuation of the road.[39] The committees must know these facts in order to estimate the amount of new money to be provided by the plan of reorganization and relative burden of fixed charges that the reorganized road may be safely asked to bear. All this mass of detail, the reorganization committee must weave into the pattern of its reorganization plan.

In all this work of preparation of the final reorganization

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mary indicates his recommendations for expenditures and his estimates of savings to be accomplished thereby.

	Additions and Betterments	Operation	Estimated Annual Savings
Freight Loss and Damage	$.........	$ 47,200	$ 520,720
Handling Less than Carload Freight	9,437	....	116,200
Reduction in Passenger Train Service	....	....	1,000,000
Light Tonnage Movement out of Chicago	....	....	185,000
Economies in Operation	....	....	2,523,342
Grade Revision or New Line	3,905,910	....	....
Lap Sidings or Second Track	1,852,000	....	....
Motive Power	990,000	....	800,000
Improvements to Existing Locomotives	1,018,675	159,100	....
Freight Equipment	2,423,256	907,174	563,470
Freight Equipment (M. C. B. repair bills)	....	....	381,700
Rails (⅔ of five-year estimate)	740,447	2,190,133	....
Rail Sawing Plant	40,000	....	....
Bank Widening	225,000	225,000	....
Ballast (⅔ of five-year estimate)	3,361,542	380,165	....
Tie Plates	3,000,000	....	....
Tie Plants and Ties	300,000	....	230,000
Yards and Terminals	2,207,000	400,000	....
Side Track Extensions	250,000	....	....
Track Maintenance	176,000	....	450,000
Bridges	279,150	430,400	....
Track Scales	38,500	4,000	....
Track Elevation and Grade Separation	3,392,000	400,000	....
Fences—Elimination of Stock Claims	309,348	....	200,000
Signal Department	291,248	....	....
Telegraph and Telephone Departments	275,000	....	257,260
Purchasing and Store Departments	120,000	....	2,216,800
Miscellaneous (estimated)	2,000,000	500,000	....
Total	$27,204,513	$5,643,172	$9,444,492
Rentals—Denver & Rio Grande	....	....	167,500
On Pueblo Union Depot	....	....	8,891
On Peoria Railway Transfer Co.	....	....	18,800
Trinity & Brazos Valley	....	....	124,139
Hire of Equipment	....	....	700,000
Grand Total Estimated Annual Savings	....	....	$10,463,822

Report of Kendrick, J. W., page 605.

The reorganization committee of the unfinished Kansas City, Mexico and Orient Railway obtained the separate reports of four well-known railroad engineers before offering a final plan of reorganization. Plan of Dec. 8, 1915, page 3. This plan is itself a very exhaustive and comprehensive analysis of a bankrupt railroad.

[39] Before the reorganization of the Pere Marquette Railroad in 1916, a physical appraisal of the property was made by Professor M. E. Cooley under the direct instructions and immediate supervision of the Michigan Railroad Commission. The cost of this appraisal, amounting to $80,808, was paid at first by the receivers of the Pere Marquette Railroad and ultimately by money provided in the reorganization.

plan, the receivers of the corporation are not considered.[40] But they report continually to the court the results of their administration of the corporation's property. From these reports the reorganization committees can form estimates of the current earning capacity of the business.[41]

Sometimes, however, the investigations of the reorganization committee involve the time element, and it is necessary to wait until the earning capacity of the corporation, under the receivership, has been fully tested. This is particularly important if the reorganization committee is dealing with a small railroad which, before the receivership, was an integral

[40] This statement is subject to exceptions—more twenty years ago than now. For example the Philadelphia and Reading reorganization plan of January, 1894, was prepared by the receivers. Receivers' plans of reorganization for industrials were quite common before 1900. 60 Chron., 1106. Meade, writing in 1901, after the railroad reorganizations of the nineties, states: "The receivers or the directors may themselves formulate a plan of reorganization, or they may appoint a committee to formulate such a plan, to which they invite the assent of the security holders." Meade, E. S., "The Reorganization of Railroads," 17 An. Am. Ac. Pol. Soc. Sci., 210 (1901). This assertion has now little significance. The tendency is for the receivers to concern themselves but little with the preparation of the plan, as courts are insisting that they remain absolutely neutral in all questions likely to cause controversy among the various security holders.

[41] Based on the improvements summarized in note 38, Kendrick estimated the earnings of the reorganized Chicago, Rock Island and Pacific Railroad as follows:

	1919	1921
Gross Earnings	$74,550,000	$76,350,000
Operating Expenses	50,918,000	48,940,000
Operating Ratio	68.3%	64.1%
Net Earnings	$23,632,000	$27,410,000
Taxes	3,986,000	4,286,000
Net Income	$19,646,000	$23,124,000
Other Income	1,368,000	1,368,000
Total Net Income	$21,014,000	$24,492,000
Rentals, etc.	2,987,000	2,987,000
Balance	$18,027,000	$21,505,000
Interest Balance	13,724,000	14,124,000
Surplus	$ 4,303,000	$7,381,000

The same engineer also made an exhaustive report, prior to the reorganization, on the future earnings of the St. Louis and San Francisco system. This is summarized by the Missouri Public Service Commission:

"Mr. J. W. Kendrick, an engineer, who made a comprehensive report on the system, made estimates of future net earnings increasing from approximately $13,000,000 in 1915 to approximately $19,500,000 in 1923. His estimate for the year ending June 30, 1916, was $13,400,000 net operating income, to which should be added approximately three-quarters of a million of miscellaneous income, making a total of a little over $14,000,000 for this year." Case 815, *Opinion and Order,* dated Dec. 22, 1915, page 27. The published net earnings of the St. Louis and San Francisco Railway (the reorganized company) for the year ending June 30, 1916, were actually $14,181,327.

part of a larger railway system. Not only must a considerable period elapse before the publication of the reorganization plan in order to allow the small independent road to indicate its capacity to originate independent traffic, but the receiver requires time to develop a new business organization and a new personnel.[42]

From the results of these investigations the general committee works out a single reorganization plan which is based on the most accurate and comprehensive knowledge available. No definitive plan is now advanced in haste. But this orderly precedure has developed, however, only within the last twenty years. Formerly plans were propounded by one committee after another, beginning almost as soon as the rumors of the impending disaster were heard.[43] In contrast to the reorganizations before 1900, it may therefore be said that the contemporary practice is to lengthen the period of preliminary investigation and adjustment, during which time no reorganization plan is published, and, so far as possible, to shorten the period of public discussion over the plan through a preliminary agreement on the part of all the influential interests to support the final plan as soon as it is published. Practically all the recent reorganizations of large corporations have run

[42] Examples are the old Colorado Midland, when it was separated from the Atchison, Topeka and Santa Fé in the last reorganization of the latter road, and the reorganization of the Buffalo and Susquehanna Railroad in 1914, after it had been separated from the railway bearing the same name. (Chapter VI, note 39.) At the present time (1919) the reorganization committees of the Chicago and Eastern Illinois Railroads are waiting to ascertain its independent earning capacity, since it has been separated from the St. Louis and San Francisco Railroad.

[43] For example, there were no less than seventeen separate plans advanced in connection with the three reorganizations of the Philadelphia and Reading Railroad: reorganization of 1882–6 plans; reorganization of 1887–6 plans; reorganization of 1896–5 plans. An illuminating survey of the almost hopeless confusion of conflicting committees and conflicting plans in an old reorganization is given in Daggett's two chapters covering the three reorganizations of the Reading. Daggett, S., Railroad Reorganization, Chaps. III and IV (1908).

A reorganization plan for the old National Cordage Company was published within thirty-six days of the failure on May 5, 1893. 56 Chron., 973 (June 10, 1893). But the plan was so premature that it had to be set aside entirely, as soon as the seriousness of the failure was fully realized.

The practice of announcing a plan of reorganization, almost simultaneously with the announcement of the failure, is still to be found among small industrials and local public utilities when the embarrassment can be attributed to a single obvious cause.

along smoothly in an orderly manner to outward appearances. The Chicago, Rock Island and Pacific, the St. Louis and San Francisco, the Pere Marquette—all of them reorganizations of railroads involving a multitude of conflicting interests—were consummated without apparent external friction once a definite and final plan had been agreed to secretly by the various committees which represented the important securities.

The most difficult and important step in the reorganization procedure is to secure a complete outward harmony of all important interests, so that all may work for the success of a common plan. All, except perhaps the senior bondholders, must make some sacrifices. But the determining power lies usually with the committee representing those securities—usually the junior mortgage bonds or debentures—of which some sacrifice is required, but which is, nevertheless, in a relatively secure position as compared with the holders of the floating debt and the stocks.[44] In other words, the determination of the plan is likely to be left to the factions which must make sacrifices. Of these, the party making the least sacrifice will probably have the deciding voice.

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[44] Stockholders' committees are rarer and have less influence in railroad reorganizations than in industrial or public service company reorganizations; the failure of a railroad is likely to occur after the equity of the stockholders is exhausted, whereas in the case of an industrial failure the stockholders, just because the funded debt is proportionately less, are more inclined to believe their equity is of considerable value. They will therefore organize themselves to protect it. Clearly the more real value the equity possesses, the more important will be the committee of the stockholders in determining the temper of the reorganization. In the Westinghouse reorganization of 1908, for example, the position of the stockholders was of importance, since the whole plan of readjustment turned on the terms on which they would consent to furnish new capital. On the other hand, if the equity is negligible and the whole weight of the reorganization falls on the creditors of the corporation, the stockholders may not concern themselves even to be represented in any stage of the reorganization. Before the reorganization of the Standard Rope and Twine Company in 1904 the affairs seemed so hopeless that the stockholders would not even come to a meeting. "Extraordinary efforts have been made to secure the attendance of the stockholders, either in person or by proxy, at the Annual Meetings, three adjourned meetings being called last year at none of which were there enough votes represented to enable the meeting to be held." 1904, S. R. T. Co., Rep. 5. In the final reorganization they had no committee of their own and were wiped out, being informed by the income bondholders' committee (whose interests were naturally in conflict with those of the stockholders) that: "Notwithstanding their earnest, persistent and long-continued efforts, they have been unable to obtain any recognition of the stock in any plan for the reorganization of your company." Circular of Oct. 30, 1905.

Out of the conflict of opinions and interests, a plan of reorganization is finally evolved which has the acknowledged support of all the committees representing the conflicting interests.[45] This plan is published before the receiver surrenders the property, or even before the foreclosure sale.[46] It is published with the recommendation of all the committees that it be accepted by the various groups of security holders.[47] The latter are asked to become parties to the "reorganization agreement," which is the formal legal document that invariably

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[45] Not always, even now, is this amicable settlement assured. The International Mercantile Marine Company was organized in 1902 as a combination of transatlantic steamship lines. It led a quiet, on the whole unsuccessful, existence down to 1914, when, owing to the general business depression, the company failed to earn the $3,248,000 required for bond interest. It passed into the hands of receivers in the spring of 1914, just on the eve of the opening of the Great War. There were 78 per cent accrued unpaid dividends on $51,700,000 preferred stock and over $7,000,000 bond interest in default. Presently a plan of reorganization was proposed which involved a wholesome reduction in capitalization and fixed charges. But it gave back to the common shareholder a mere pittance of an equity in the reorganized company. On the basis of the corporation's past history this reorganization plan was thoroughly wise and in accord with just and conservative financial practice. But the Great War had changed conditions entirely. The average annual net earnings of the years from 1902 to 1910—with inadequate depreciation charges—were less than $4,000,000. In the single year of 1915 the company earned, before war taxes and special depreciation reserves, over $40,000,000—more than ten times its previous average annual earnings. During the first two years of the Great War its net earnings were reported to exceed its total outstanding bonded debt. On the basis of this showing, the common shareholders organized a committee and fought the previous reorganization plan. A bitter controversy resulted. But the final plan was much more liberal to the common shareholders than was the plan which was first proposed.

[46] It is inexpedient for the members of the committee to take steps to secure the reorganization until after the plan has been announced. No such action is usually provided for in the original deposit agreement, and an assumption of authority would be interpreted by the security holders, and even by the courts, as evidence of coercion. In one noted case the deposit agreement under which the reorganization committee acted provided that the committee could buy the railway property after it had announced a plan of reorganization. It bought the property before the announcement. The court decided this was a breach of contract, notwithstanding the very general powers granted the committee. Industrial, etc. v. Tod, 180 N. Y. 215 (1905). In order to forestall obstructionists, Cravath advises that a foreclosure decree be obtained before the announcement of the plan; and permission so to do must be included in the original deposit agreements. Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 169 (1917). On the other hand, any such procedure prevents any voluntary settlement among the security holders on the basis of an eminently fair and advantageous plan—as in the Baltimore and Ohio reorganization of 1899. There was one notable case, the Texas and Pacific reorganization of 1887, in which a voluntary adjustment with all the security holders was made after the foreclosure sale, so that the sale was never confirmed.

It is, however, necessary to note, in passing, in view of the Tod case above mentioned, that the reorganization committees must not overstep any of the powers or limitations and restrictions specifically imposed upon them by the deposit agreements under which they are acting. See also United Water Works Co. v. Omaha Water Co., 164 N. Y. 41 (1900).

[47] It is quite common for the plan to be published as the joint work of all the committees. For example, the Metropolitan Street Railway reorganization plan of November 29, 1911, was signed directly by the "Five Per Cent Committee," the "Four Per Cent Committee," and the "Joint Committee." Ordinarily the "joint" or general committee is deemed to be acting for all the other committees.

accompanies "the plan."[48] By so doing, they assent to the terms of the reorganization, and on paying their assessment, if any is called for, receive their allotted securities in the new corporation. Those who do not care to accept the terms of the reorganization are allowed to withdraw the securities originally deposited,[49] usually on the payment of a small fee to cover the expenses of the committee. If, as is probably the case, a very large proportion of the security holders consent to the conditions, the reorganization committee declares the plan operative, and the reorganization is finished except for the legal formalities.[50]

These legal formalities are, however, often very perplexing, and depend largely on the attitude of the old security holders. If practically all the security holders accept the plan, surrendering their old stocks and bonds, then no pressure upon a recalcitrant minority need be exerted. There need be no judicial sale of the old corporation's property, and no surrender of its charter. This was what happened in the great reorganization of the Baltimore and Ohio Railroad in 1899. But a complete adjustment with all the claimants and security holders is usually impossible. Some persons will feel themselves aggrieved in any plan of reorganization, and there are always

[48] Care should be taken to distinguish between the "reorganization plan" and the "reorganization agreement." The former is the short, comprehensive statement of the financial side of the reorganization; it is an easily understood document, free from legal verbiage, and intended for wide distribution. The "reorganization agreement" is an elaborate legal document. It covers the details of the "plan," together with a full and presumably exhaustive statement of the powers and limitations of the committee or committees which will carry out the "plan," the rights of the assenting security holders, and a detailed account of the machinery by which it is proposed to consummate the reorganization. Cravath writes an illuminating defense of the inordinate length of the modern reorganization agreement. Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 176 (1917).

[49] Colonial Tr. Co. v. Wallace, 183 Fed. 896 (1911).

[50] Ordinarily finished. The plan having been declared operative, the various contracts of security holders, syndicate subscribers, and debt claimants become binding. But the plan may be subsequently modified—provided always that the modifications are acceptable to the contracting parties—and it may even be set aside entirely and a new plan adopted. Generally speaking, however, when the plan has been declared operative, it indicates that the main adjustments have been accomplished and only the loose ends remain unfinished. These may require considerable time, as the wheels of equity procedure move slowly, but to all outward intents and purposes the reorganization has been consummated.

strikers—to be discussed presently—who will seek to impede the progress and try to create for themselves a nuisance value, in hopes that the reorganization managers will buy them off at some factitious price. To carry out the obvious will of the great majority of assenting claimants and security holders, the reorganization must be forced through and the dissenting minority and obstructionists settled with in a just and open manner fully approved by the court.[51] This is accomplished by the judicial sale of the old corporation's property through a decree of foreclosure.

In theory, at least, the foreclosure of a mortgage on any property, however extensive, is similar to that of the foreclosure of a mortgage on a house,[52] but in actual practice the doctrine has been modified so far as it concerns the properties of large corporations, especially great railway systems. The courts tolerate the doctrine that the "foreclosure proceedings of mortgages covering extensive railroad properties are not necessarily conducted with the limitations that attend the foreclosure of ordinary mortgages." [53] In fact, it was recognized long ago that the court might arrange the formal steps in the foreclosure with a view to facilitating the execution of a plan of reorganization already agreed upon and, by implication, approved by the court.[54] If need be, the court may even order

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[51] The court, by approving of the conditions of the judicial sale, may indirectly force the dissenting minority to accept the plan of reorganization approved by an overwhelming majority of security holders. But the court cannot directly force a security holder to accept a plan. "It is clear that the courts cannot directly or indirectly rewrite this reorganization agreement." Guar. Tr. v. Inter. Steam Pump Co., 231 Fed. 594 (1916). This was tried in one notable case, but the United States Circuit Court of Appeals (Supreme Court Justice Brewer rendering the opinion) declared against any such use of the court's power on the ground that "there is no wide discretion vested in the chancellor which permits him to disturb contract rights—the rights of property. . . . It is not for the court to assume the power to compel because it believes it wise and good business. . . . Every man in this country decides questions in respect to his own property for himself." Merchants Loan and Trust Co. v. Chicago Rys. Co., 158 Fed. 923 (1907).

[52] It is the customary practice for the trustee of one of the junior mortgages just above those underlying mortgages which are not to be disturbed in the reorganization, to move for a judicial sale of the corporate property of the railroad. This position is usually unopposed by the railroad. For details of procedure, see Byrne, J., "Foreclosure of Railroad Mortgages," in Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation (1917).

[53] Louisville Tr. Co. v. Louisville, N. A. & C. Ry. Co., 174 U. S. 674 (1898).

[54] Soye v. Central R. R. Co., 99 U. S. 334 (1878).

a sale of the corporation's property before the status of different claimants is determined, on the assumption that the quicker the reorganization is carried out, the better it will be for all concerned.[55] Here, as elsewhere in this complicated subject, lies the general rule that the courts have sought to facilitate the adjustment of purely private dissensions with a view first of all to the larger questions of public policy. Judging from the words of perhaps the ablest student of reorganizations, they have not abused this power.[56]

The next step is the "decree" of sale, according to which the court preserves the outward form of a foreclosure sale.[57] Owing to the fact that the foreclosure of the property of a great corporation requires far more capital than a single man or group of men can command, the court recognizes that there will be no competition at the foreclosure sale of the property. In order to prevent the various parties who have agreed among themselves upon a workable plan of reorganization from conspiring together to purchase the property for little and thus defeat the just claims of other creditors who have not pooled their interests, the court ordinarily fixes a minimum or "upset" price.[58] It is the amount which the receivers must realize from the property in order that the court shall confirm the sale. It amounts, practically, to the determination by the court of the price at which the reorganization committee may acquire the property of the old corporation at a public sale, and also of the conditions under which the committee must settle with the creditors who have not consented to its

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[55] First Nat. Bank v. Shedd, 121 U. S. 74 (1886). See also Ala. & Ga. Mfg. Co. v. Robinson, 72 Fed. 708 (1896); Guaranty Tr. Co. v. Metro. Street Ry. Co., 168 Fed. 937 (1909), and 177 Fed. 925 (1910).

[56] "It is a source of pride, or ought to be, to every lawyer and man of business, that as a rule our federal tribunals have so used their powers as to conserve the right of property and to bring about the greatest good to the greatest number regardless of mere technical rules." Joline, A. H., Lectures, Graduate School of Business Administration, Harvard University, 83.

[57] For a description of the legal details, involved in carrying out the sale, see Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 139 (1917).

[58] Ibid., 202 (Cravath, P. D.).

plan.[59] There is, theoretically at least, a chance that other persons may care to pay more for the property than the reorganization committee[60] and the general creditors not embraced in the committee's plan should be given—theoretically at least—an opportunity to bid in the property in satisfaction of their own liens. Moreover, the public sale preserves the form of legal procedure required in the foreclosure of a mortgage on a plot of land. But it is a foregone conclusion that the only bidder will be a representative of the reorganization committee, and his bid will represent a few dollars more than the court's upset price.[61] Accordingly, in recent practice, many courts,[62] to avoid the expense and notoriety connected with a public sale, authorize the receivers to give notice that they propose to sell at private sale the property of the corporation to the reorganization committee in furtherance of their prearranged plan of reorganization. If anyone objects or can guarantee that a larger sum will be obtained at a public offering, the court will authorize it. Ordinarily no one objects, and the plan is carried out at a distinct saving of expense.

If no upset price is fixed, or if it is very high, the bid obtained by the receiver may be less than what the court deems just. A second, or even third, sale may be ordered

[59] The strict law is that the acquiring company is in no wise liable for debts or other obligations created by the receiver while managing the corporation. Godfrey v. Ohio and M. Ry. Co., 116 Ind. 30 (1888); Davis v. Duncan, 19 Fed. 477 (1884); also 67 Fed. 456 (1895); 71 Fed. 636 (1895); and 83 Tex. 286 (1892). But this principle, based on the old and now antiquated theory that the receiver is merely a temporary trustee, is not observed in practice. Invariably, in the case of a large public service corporation, and usually, in the case of a small industrial corporation, the receiver has improved and made the corporate property more valuable during his administration of it. That being the case the court, in confirming the restitution of the property to the reorganization committee and the new corporation will require that the latter shall assume the liabilities incurred by the receiver. Balt. R.R. Co. v. Buris, 111 Fed. 882 (1901).

[60] Very seldom indeed is this chance realized. Cleveland and Powell cite the interesting example of the Cape Fear and Yadkin Railroad, which was bid in by the Atlantic Coast Line interests in opposition to the plan of the reorganization committee acting for the Seaboard Air Line Railway. 67 Chron., 1355.

[61] As very succinctly stated by Byrne: "The railroad company is an empty shell; its bondholders, creditors and stockholders are going to be the purchasers and to be, with such people as agree with them to put fresh money into the property, the bondholders and stockholders of the new company which is to own the road after foreclosure sale." Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 142 (1917).

[62] Particularly those of New Jersey.

in the hope of obtaining more.[63] Sooner or later, the sale is confirmed by the court[64] and the property comes into the possession of the new owner—the reorganization committee; and, automatically, the administration of the receiver ceases.[65]

The reorganization committee, having acquired the property, immediately turns it over to the new corporation. This the committee has caused to be formed even before the final settlement. The same name is retained in the case of the reorganization of a public service corporation, except that "railroad" may be changed to "railway" or "company" to "corporation." [66] But in the case of industrials the name of the new

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[63] At the first receivers' sale of the assets of the National Salt Company the highest bid was $337,500. Certain minority interests alleged that a conspiracy existed between the receivers and the majority stockholders, and petitioned the court not to confirm the sale. The petition was granted. Prior to the sale an independent appraiser had valued the property at $1,149,200 and even $694,200 at forced sale. Yet at the second sale only $193,310 was realized. 77 Chron., 773; 78 Chron., 823, 1552.

[64] Often the court is requested not to confirm the sale, even after the upset price has been obtained, on merely technical grounds. Usually such a request is made by a recalcitrant minority interest for the purpose of delaying the reorganization. In 1914 the unfortunate Kansas City, Mexico and Orient Railway was sold at receivers' sale for $6,001,000—the court's upset price being $6,000,000. In March, 1915, a bondholder of the road petitioned the United States district court to have the sale set aside on the ground that there had been collusion between the creditors not protected by a mortgage and the depositing bondholders. The petition availed nothing; but the reorganized road was unsucessful and it passed into receiver's hands again, April 16, 1917.

[65] The only exhaustive study made of the relative lengths of receivership is that of a table compiled by Swain, published in 1898. Using this table, with certain interpolations and adjustments, it may be said that of the 610 railroad receiverships established prior to January 1, 1894, 110, or 18 per cent, lasted less than one year; 147, or 24 per cent, between one and two years; 115, or 19 per cent, between two and three years; 85, or 14 per cent, between three and four years; and the remainder, 153, or 25 per cent of the whole, lasted more than four years. Altogether, the average duration was two years, ten months. Swain, H. H., "Economic Aspects of Railroad Receiverships," 3 Economic Studies (Am. Econ. Assn. [1898]).

The writer is of the opinion, although he has compiled no statistics to prove it, that the length of railroad receivership has increased of late years. Prior to 1890 so many small roads, whose affairs could be easily adjusted, passed into the hands of receivers that the average period was less. Recently, however, owing to railroad consolidation, every receivership represents an intricate problem which requires a comparatively long time to solve. Moreover, the standards of efficiency are much higher than before 1893, and a court is reluctant to loosen its grasp on a railroad property until it is assured that permanently good service can be rendered to the public.

[66] This is the commonest subterfuge. It was first used, to the knowledge of the writer, for an important railway system, when the Pittsburgh, Fort Wayne and Chicago Railroad was reorganized, February 26, 1862, into the Railway of the same name. It is worked back and forth. First there was the St. Louis and San Francisco Railway. It became the "railroad" through reorganization, in 1896, and again the "railway" in 1916. Infrequently there is a slight transposition in the title itself, as when the Battle Creek and Bay City Railway became the Bay City and Battle Creek Railway after a reorganization in 1889. The Memphis and Little Rock Railroad was sold at foreclosure sale and became the "railway." This was foreclosed a second time and became the Little Rock and Memphis Railroad. It was foreclosed a third time and became the "railway." 30 Am. Law Rev., 161; 20 Fed. 260 (1884).

corporation is almost invariably made different from the old one. The reason for this variance in practice between public utility and industrial reorganizations is that the financial embarrassment and subsequent reorganization of a railroad or local electric company does not ordinarily impair its standing with its customers. A large part of the traveling public do not know when a railroad passes in and out of a receivership; the public would be inconvenienced were the fact needlessly emphasized or were its established corporate name changed. The failure of an industrial, on the other hand, implies an impaired or a ruined credit. The quicker, therefore, the associations connected with the old company are forgotten, the better it is for the credit of the reorganized company. A new name tends to obscure the memories of the past.

The most difficult problem remaining to the reorganization committee after the sale is that of the final adjustment of conflicting interests. The questions connected with this problem have been affecting all the tentative plans and later stages of the work of the various reorganization committees. They represent the loose ends and possible sources of embarrassment and litigation that invariably cast their shadows about every reorganization of importance. In case all the bonds are of one class, are all deposited with the reorganization committee, and no other creditors exist, the transition from control by the receivers to that of the new corporation occurs without a possibility of friction. But such simplicity is seldom if ever present in any reorganization of considerable size. There are always claims to be adjusted. If the upset price exceeds the face value of one or more issues of underlying bonds, these bonds are not affected; in the vocabulary of finance they are "undisturbed." If the upset price does not equal the face value of a bond issue, some adjustment is necessary with those of the bondholders who have not consented to enter the reor-

ganization and they are invariably paid off in money raised by the reorganization committee as part of their plan. The amount each non-assenting bondholder receives is the proportional part the face value of his bonds bears to the sum received by the court from the sale of the actual property securing them. Unless the bonds are secured by very valuable physical property the amount allotted to the non-assenting bondholders is usually very small.[67]

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[67] The Asphalt Company of America, to illustrate the case among industrials, had outstanding upwards of $30,000,000 of bonds. The company failed and the court fixed an upset price for its property, together with that of an allied company, at $6,000,000. It was sold for $6,006,000, of which $3,120,000 was for the assets behind the $30,000,000 of bonds. From this amount expenses of the sale were subtracted and the adjusted amount divided by the outstanding par value of the certificates. The quotient was $104.68, which is the equity rightfully belonging to each bond. But those of the bondholders who went into the reorganization took the stocks of the new company in liquidation of their claims—as the reorganization plan contemplated. Those who did not were paid off at the rate of $104.68 for each $1,000 par value of bonds.

A somewhat elaborate study can be made of the payments to the non-assenting security holders from the results of the last Pere Marquette Railroad reorganization. (Details of this reorganization given at length in Chapter V, and Chapter VI.) In this reorganization every security was either refunded or wiped out, so that if any equity remained to any of the bond issues, and any of the holders of the bonds refused to exchange their securities for the new securities of the reorganized corporation, then their proportional part of the equity would have to be paid to them in money before the mortgage under which the bonds were originally issued could be discharged from the record. There were twelve bond issues that were considered to have a direct lien on physical property, or valuable equity in physical property. Two of them could be discharged on the record without formal foreclosure, as holders of all the bonds issued under them accepted the plan. Of the remaining ten issues, the following represent the settlement prices with the non-assenting bondholders (for each $1,000 par value and unpaid coupons).

UNDERLYING MAIN LINE BONDS	
Flint and Pere Marquette 1st 6's	$853.32
(Underlying first mortgage on main line)	
Detroit, Grand Rapids and Western 1st Cons. 4's	650.68
(Underlying first mortgage on main line)	
Chicago and West Michigan 1st 5's	773.57
(Underlying first mortgage on main line)	
UNDERLYING BRANCH BONDS	
Indiana Division	592.59
(Underlying mortgage on important branch)	
Port Huron Division	343.87
(Underlying mortgage on unimportant branch)	
Chicago and North Michigan	314.94
(Underlying mortgage on unimportant branch)	
Grand Rapids, Belding and Saginaw	230.77
(Underlying mortgage on unimportant branch)	
GENERAL MORTGAGE BONDS	
Flint and Pere Marquette 1st Cons. 5's	701.74
(General mortgage covering principal parts of system)	
Pere Marquette Cons. 4's	460.90
(First general mortgage for whole system)	
Pere Marquette Ref. 4's	117.01
(Second general mortgage for whole system, some additional securities pledged)	

For further discussion of the refunding of these bonds see Chapter VI. As explanation of the above differences in the settlement prices, the relative status

In addition to the payments to the non-assenting bondholders—involving a relatively simple problem—some kind of settlement must also be made with the other creditors who refuse to consent to the plan. These active and latent objectors are called "strikers." They are of two groups. There are the general creditors of the corporation, who have furnished it with labor and material before the failure and who, being relatively few in number, have neither organized nor otherwise intervened in the proceedings. They cannot be neglected, and provision is made that their claims may be paid entirely

of each issue as given in Chapter VI, page 141, should be noted, together with the differences in amounts outstanding of the different issues.

The entire subject of the cash or final liquidation value of old bonds issued under foreclosed mortgages has never been adequately discussed. After foreclosure the money representing the proportion of the sale price that should be paid over to the non-assenting bondholders is paid over to the court or courts having supervision of the sale. Smythe cites a case of the foreclosure money of an old telegraph company that was divided up among four different courts. Smythe, R. M., Obsolete Securities, II, 9 (1911). As a result of the foreclosure of many railroad mortgages from the Civil War down through the panic of 1893 a considerable sum of money, in the aggregate, was paid into the various courts. As the old unpresented bonds turned up the holders could get their decree value by merely presenting them to the proper court. But in 1897 Congress passed a law (29 Stats. at Large, 578) which provided that "it shall be the duty of the Judge or Judges . . . to cause any moneys deposited as aforesaid, which have remained in the registry of the Courts unclaimed for ten years or longer, to be deposited to the credit of the United States." Ibid, Sec. 996. Once the money has passed into the United States Treasury it has been found almost impossible for the holder of an old unpresented bond to get any of the money out.

Smythe, R. M., in his interesting volume on Obsolete American Securities and Corporations II, 12-17, gives a list of some forty old bonds with their decree value. The following list of twenty-two are representative. They are all first mortgage bonds on railroads which, in their day, were of considerable importance.

Old Name	Date of Issue	Date of Default	Decree Value (per $1000)
Buffalo, Pittsburgh and Western Rd.	1881	1884	$295
Central Iowa Ry.	1879	1884	100
Charleston and Savannah Rd. (Guaranteed by State of South Carolina)	1857	1877	334
Chicago, Danville and Vincennes—Illinois division	1869	1873	520
Chicago, Danville and Vincennes—Indiana division	1872	1873	43
Chicago, Kansas City and Texas Ry.	1887	1891	17
Cincinnati, Columbus and Hocking Valley Rd.	1882	1885	25
Cleveland, Delphos and St. Louis Rd.	1881	1884	17
Danville, Urbana, Bloomington Rd.	1869	1874	168
Dutchess and Columbia Rd.	1868	1874	175
East and West Rd. of Alabama	1885	1887	250
Indianapolis, Bloomington and Western Ry.	1869	1874	75
Kanawha and Ohio Ry.	1886	1889	331
Marietta, Pittsburgh and Cleveland Rd.	1874	1875	70
New Jersey and New York Rd.	1873	1876	7
New York, Pittsburgh and Chicago Ry.	1883	1885	19
New York and Oswego Midland Rd.	1869	1874	234
Northern Pacific Rd.—7.3%	1870	1874	7
Ohio Central Rd—River Division	1882	1883	319
Pittsburgh, Titusville and Buffalo Ry.	1876	1885	96
Quincy, Omaha and Kansas City Ry.	1887	1890	17
Selma and Gulf Rd. (Guaranteed by State of Alabama)	1871	1875	103

or partially out of the money subscribed at the time of the reorganization. In case they are not satisfied with the adjustment accorded them, one or more may begin legal proceedings to set aside the foreclosure sale or otherwise hinder the course of the reorganization. The legal standing of these general creditors is by no means clearly defined, but the leading Kansas City Southern case[68] seems to countenance the theory that they may be ignored if the railroad property is worth less than the mortgage debt, but must be included in the reorganization if the property is worth more.[69]

[68] Kansas City Southern Ry. Co. v. Guardian Tr. Co., 240 U. S. 166 (1916).

[69] In one notable case a general creditor was able, through a noteworthy decision of the Supreme Court, to annul the work of the reorganization committee merely because an agreement had been reached between the stockholders and the bondholders. An agreement between the stockholders and creditors is invariably entered into as a necessary part—perhaps the most important part—of every reorganization plan which involves the stockholders at all. Yet in this case the court seemed to assume that such an agreement, looking toward the foreclosure of the corporate property by the stockholders and bondholders, no matter under what conditions, was likely to work harm to the excluded general creditor, because he would be, ordinarily, not strong enough to defend himself against a combination of security holders. This was the famous Monon case. Louisville Tr. Co. v. Louisville, New Albany & Chic. Ry. Co., 174 U. S. 674 (1898). The law of the matter has latterly been still further clouded by the now equally famous Northern Pacific or Boyd case, in which the court allowed an unsettled judgment against the old Northern Pacific Railroad to be levied against the new, reorganized Northern Pacific Railway, on the ground that the reorganization plan made no provision for the unsecured creditors, while it permitted the old stockholders to retain an interest in the new railway company by the exchange of old shares for new. Nor. Pac. Rd. Co. v. Boyd, 228 U. S. 482 (1913). "Any device," said the prevailing opinion of the Supreme Court, "whether by private contract or judicial sale under consent decree, whereby the stockholders were preferred before the creditor, was invalid." (504.) Or again "a transfer by stockholders from themselves to themselves cannot defeat the claim of a non-assenting creditor. As against him the sale is void in equity, regardless of the motive with which it was made." For comprehensive account of the Boyd case, see the illuminating essay by Cravath, P. D., in Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 191 (1917). On the other hand, a long series of legal decisions, based on the theory that the general creditors have the privilege of combining together and buying in the property, the same privilege possessed by other creditors, has given legal support to the machinery of reorganization and the final settlement with all creditors on the basis of the arbitrary upset price determined by the court. For instance, in an opinion delivered by the Supreme Court soon after the Monon case, the legality of a sale of property to the reorganization committee was upheld even though the committee had promised to give the old stockholders an interest in the new corporation. The only question was this—Was the property worth more than the mortgage bonds? If it was, then the general creditor had an interest in the equity; if it was not, then the general creditor had none. In the latter case, the mortgage bondholder could, if he chose, surrender some of his interest in the property to the stockholder—or anybody else—without defrauding the general creditor. Dickerman, Trustee v. The Northern Tr. Co., 176 U. S. 181 (1900). And in the rehearing of the Monon case, above referred to, this view was maintained by the federal court. 103 Fed. 110 (1900). And the theory may be regarded as generally accepted, in spite of the apparent anomalies of the Monon and Boyd decisions, that the foreclosing bondholders may do with the property as they like, provided there is no equity remaining to the general creditors from which they were fraudulently debarred. Kan. City Sou. Ry. v. Guardian Tr. Co., 240 U. S. 166 (1916). Yet the courts very naturally scrutinize, with great care, a reorganization agreement in which the stockholders are admitted to an interest in the new company,

The other class of "strikers" are the security holders who object to the conditions of the plan or the general procedure connected with the sale of the property, or even the execution of the reorganization agreement.[70] Although not ordinarily powerful enough to reorganize the company in their own way, they are in a position to delay the reorganization by litigation. Sometimes these strikers have a real grievance. In the Philadelphia and Reading reorganization of 1887 the majority of a junior issue of bonds formulated a plan in opposition to that adopted, and agreed among themselves not to comply singly with the provisions of the operative plan. Ultimately the committee felt compelled to pay them the par value of their bonds.[71] There are speculators in New York who make it their business to "hold up" reorganization committees, and such is the impatience of business men, such the possible delays in litigation, and such the expenses of a prolonged receivership, that strikers are ordinarily bought off. This practice only aggravates the evil. One man in particular has obtained

if the old company's debts are not all paid. "Unquestionably the sale of a railroad property under foreclosure proceedings to a committee of reorganization, according to whose plan the stockholders of the mortgagor company appear to obtain some benefit in the purchasing company, is open to the closest scrutiny." Joline, A. H., Lectures before the Graduate School of Business Administration, Harvard University, 52. Any suggestion of fraud, coercion, or injustice will defeat the proceedings. "But where," in the words of the Chicago and Erie decision, "in ordinary course, foreclosure is instituted and carried out for the honest purpose only of enforcing against the property the mortgage obligation, the mere fact that shareholders of the old company may, under a purchasing arrangement, become interested in the securities of the new, will not make the foreclosure per se fraudulent. . . . We see no reason why the purchaser for reorganization may not include any one whom he chooses to take into the organization, and may not contemplate even an exchange of some of the new securities for outstanding shares. To the extent that the property is worth something more than the mortgages, the general creditors are interested in any subsequent distribution. But beyond that, their interest does not extend." Wenger v. Chi. & Erie Ry. Co., 114 Fed. 34 (1902).

[70] See Cravath, P. D., in Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 202ff (1917).

[71] It should be noted, however, that the committee was anxious to effect the reorganization without foreclosure proceedings, as there were reasons to suppose that the old charter was valuable and should be preserved. Had the committee been willing to foreclose, this "settlement" would have been unnecessary. (See Chapter II, note 16, and surrounding text.)

In rare instances these strikers have cause for objecting to some basis of settlement. In the reorganization of the Asphalt Company of America, the dissenting bondholders, who had been offered only $105 for each $1,000 bond, had brought to light fraud and misrepresentation by the very interests which reorganized the company. Some of them brought suit to recover a portion of their losses, alleging that the original stockholders had still an unextinguished equity. They were finally paid at the rate of $500 for each $1,000 bond. (See note 67 of this chapter, first paragraph.)

an unenviable reputation by his numerous exploits. The fact remains that, in spite of questions of ultimate justice, in a field where justice is necessarily tempered by expediency, the effort of a few to exact onerous terms from a majority by using or threatening to use the courts for purposes of delay, can hardly justify itself, whatsoever the plea.[72] At all events it is necessary to remember in considering the fundamental justice of the claims of a few, that such has been the depletion of the corporation's property, due to its misfortunes, that no one can claim the fulfilment, to the last letter, of his strict legal and equitable rights. To some extent, at least temporary losses must be borne by all concerned. And if there exists any possibility of recovering these losses, the new corporation should be placed on its feet at the earliest possible moment. This is the tacit assumption behind all the procedure of reorganization.

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[72] That the course of a reorganization cannot be obstructed by a small group of objectors has been clearly and succinctly put by the Supreme Court: "To allow a small minority of bondholders, representing a comparatively insignificant amount of the mortgage debt, in the absence of any pretense of fraud or unfairness, to defeat the wishes of such an overwhelming majority of those associated with them in the benefits of their common security, would be to ignore entirely the relation which bondholders, secured by a railroad mortgage, bear to each other." Shaw v. R. R. Co., 100 U. S. 605 (1879). Quoted by Cleveland and Powell, Railroad Finance, 254 (1912).

The late Adrian H. Joline put the matter well when he said: "I confess that I have a most profound contempt for most of these 'bona fide holders' who try to block reorganizations; usually I could name two or three men who are responsible for these blackmailing enterprises. . . . I speak of this, because I want to impress upon you that almost all the outcry against reorganizaion methods comes from people who are only insincere, selfish speculators, without any genuine interest in the business, hanging on the outskirts of these enterprises in the hope of picking up some fragments." Joline, A. H., Lectures before the Graduate School of Business Administration, Harvard University, 86. Cravath also has said: "There are a certain number of men who make it a profession to watch reorganizations and other large corporate transactions with a view to instituting litigation at some critical moment in the hope of creating a nuisance value for themselves." Cravath, P. D., in Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 202 (1917).

With reference to the obstructionists to the United States Leather Company's reorganization, it was stated that: "A large part, perhaps a majority of these holdings [those of the objectors to the plan] were acquired . . . after the plan of reorganization was announced. Several of those loudest in their protestations of injustice did not acquire their securities until after the Committee had declared the reorganization plan operative." Dewing, A. S., "The Reorganization of the United States Leather Company," 26 Q. J. E., 68 (Nov., 1911).

In one notable instance, that of the reorganization of the National Salt Company, the strikers lost all their stakes as the securities they held became worthless—due to the enforcement of prior liens—while they were engaged in obstructing the reorganization.

CHAPTER IV[1]

THE REORGANIZATION OF RAILROADS[2]

The practices, conventions, and guiding principles, both legal and financial, governing the reorganization of railroads have been more firmly and definitely established than those controlling the reorganization of any other type of corporation. When, therefore, the government assumed control of the railways of the country, January 1, 1918, both the theory and the detailed working out of the financial rehabilitation of a bankrupt railroad were clearly understood. For the reason, therefore, that railroad reorganization, although extremely intricate, is a relatively finished subject, its historical development and present status will be discussed in considerable detail.

Contemporary practice covering the reorganization of both small and large railways has grown up in direct response to the needs of a rapidly building national railway system, not

[1] Large portions of this chapter appeared as parts of periodical articles dealing with the same subject. Dewing, A. S., "The Theory of Railroad Reorganization," 8 Am. Ec. Rev., 774 (Dec., 1918), and "The Purposes Achieved by Railroad Reorganization," 9 Am. Ec. Assn. Rev. (June, 1919).

[2] While this and the next two chapters describe especially the current practice in the reorganization of steam railroads in the United States, the principles may be said to apply, with insignificant variations, to the reorganization of traction corporations. When read in connection with a later chapter on industrial reorganizations, the contrast, so far as such exists in practice, between the reorganization of a public service and that of a private corporation may become clear.

always balanced and not always financially sound in its parts. Moreover, like the railway net itself, the present practices concerning financial reorganization pertain to the period of construction and development, the period of the gradual dawn upon our intelligence of the importance of railway transportation, with the accompanying pangs of our political and social consciousness in adjusting themselves to the rapidly changing economic organization that this importance demanded. It has been essentially an American problem. Our financiers have had no historical or transatlantic precedents to guide them. Notwithstanding this, the development of the theory and practice of railroad reorganization is one of the most original and remarkable achievements of American business genius.[3]

Great emphasis has been laid already[4] on the frequency of overexpansion as a cause of corporate failure. This importance cannot well be overemphasized in discussing railroad failures. In the very earliest days of railroad building this evil showed itself in the extension of railroads into well-developed territory without measuring the cost of construction; during the third quarter of the last century it took the form of extension into territory insufficiently developed, economically, to maintain a railroad.[5] Subsequently, failure has resulted from the overbuilding of branch line feeders in the hope of "creating" new traffic. Still more recently railroad systems have been afflicted by the weakness incident to mere size, such as combination of several groups into single vast systems or even (as has been true many times) the embarkation of the railroad in other remotely connected industries.

[3] It was well said that: "The reorganization of American railways is a more noteworthy achievement than the payment of the French indemnity or the refunding of the United States debt. It is noteworthy not merely in the amount of securities involved, but on account of the excellence of the principles which have guided its managers in their action." Meade, E. S., "The Reorganization of Railroads," 17 An. Am. Ac. Pol. Soc. Sci. 242 (1901).

[4] Chapter II.

[5] This is true of practically all the railroad failures occasioned by the panics of 1873 and 1884.

With this overexpansion, the business as a whole earned a steadily declining rate of return on the average unit of investment.[6] It became thinner, through a rather rigid application to the railroad industry of a kind of diminishing return on capital investment. As large amounts of money were required to meet the costs of extensions, overexpansion of a railroad was accompanied, almost inevitably, by an increase in the funded debt, both relatively to the total invested capital and absolutely per mile of railroad. Two tendencies, therefore, operated at the same time, a decrease in earnings and an increase in the interest payments required by the funded debt. Ultimately the interest charges exceeded the earnings and the company failed.[7] But this failure was invariably postponed by the operation of palliatives—first the expenditures for maintenance were cut to the marrow and then a large floating debt was piled up.

In view of these generalizations, surprisingly free from exceptions, if one considers the variety of origin, location, and administration of our railroads, it is possible to observe that every railroad reorganization must penetrate beneath the tangle of proximate causes and either lop off the wasting parasitic growths resulting from overexpansion, or else so remould the financial plan of the railroad that the interest charges shall be less, not greater, than the net earnings. Frequently the reorganization plan has involved a reduction in mileage, especially in those cases of most obvious overexpan-

[6] Observe the comparative tables of the New Haven system at different periods of its expansion. Chapter II, note 21.

[7] Until recently it was almost universaly true that the admitted failure of a great railway system did not occur while the net earnings were clearly greater than the interest charges. Yet the failure of the St. Louis and San Francisco Railroad, because of inability to meet the principal of short-time notes, and the receivership of the Boston and Maine in February, 1915, because of the same reason, leads one to question the generality of the above statement, which ten years ago would have gone unquestioned. In the two cases just cited the two roads were, apparently, earning the interest on their obligations. Heretofore if a road was able to show interest earned, it ordinarily experienced no difficulty in refunding maturing bonds. The inexcusable practice, now frequently indulged in by railroads, of making permanent improvements from the proceeds of short-time notes introduces new complexities into the entire situation.

sion. Although this may be a tacit admission of previous mistakes, the old management invariably ascribes the failure to superficial rather than ultimate causes. Consequently the other alternative, that of recasting the financial plan so that the fixed interest charges shall lie well within the earnings, is the underlying motive of every reorganization. About this, every other feature of the reorganization turns. It is felt by all concerned that failure was due to maladjustments resulting from rapid expansion, and not to the expansion itself. It is assumed, therefore, that if the road is given relief from its overpowering burden of fixed charges, it will recover its poise. Railway pioneers in earlier days, and railway expansionists in the last epoch, have been constitutionally optimists; they prescribed merely a rest for their patient—not surgery. The history of railroad reorganization practice, as we shall see presently, has been the history of a gradual realization that the rest, to be permanently curative, must be accompanied by surgery.

Reduction in fixed charges was, therefore, the primary purpose of every railroad reorganization, but it was not the only purpose. It has been stated already that a railroad on the verge of bankruptcy can postpone the acknowledgment of its failure by two means—a reduction in the expenses necessary to maintain the physical integrity of the road, and an increase in the amount of its floating debt. Both means are adopted. Consequently when failure is finally admitted through the appointment of a receiver, the court finds the road very much out of repair because of insufficient maintenance expenditures, and heavily weighed down by a burden of floating debt. Formerly the rehabilitation of the road and the liquidation of the floating debt were allowed to wait until the period of reorganization; but of recent years courts have permitted receivers to borrow money on their own certificates for these purposes. In any event, the plan of reorganization

must provide sufficient money either to rehabilitate the road and pay its prereceivership debts directly, or else to pay the receivers' certificates which had been sold for the purpose of accomplishing these ends during the receivership. Ample new money, then, under any circumstances, is the second essential purpose of every railroad reorganization. And since the credit of the bankrupt property is low, both because of its previous history and the notoriety given to it by the fact of a receivership, outside investors will not buy its securities. The new money must be exacted from the old stockholders who are the only persons sufficiently interested in the property to make sacrifices to help it in its hour of need.

While these two purposes, a reduction in fixed charges and the collection of new money from old security holders, have been the paramount issues in every railroad reorganization, they have not been accomplished by the same means. This is what makes the analysis of railroad reorganization difficult if one stresses the means employed, rather than the ends achieved. On the other hand, since the ends to be achieved are so strikingly uniform, we can define a railroad reorganization as a comprehensive change of the financial plan, necessitated by impending or actual failure, such that the fixed charges are reduced and new money is supplied through the sacrifices of security holders.[8]

The means for accomplishing these ends have undergone radical changes and it is in the light of the history of the subject that the present theory and practice of railroad reorganization are best understood. Historically, the practices pursued in dealing with a bankrupt railway may be divided arbitrarily, yet with considerable definiteness, into various periods separated from each other by the successive panics. For in actual experience the panic years have served as nodal

[8] For other definitions of railroad reorganization, see Chapter I, note 9.

points to the development of railway finance. Weak railroads have failed in great numbers at those times.[9] Consequently these periods have witnessed the most fundamental and conspicuous changes in reorganization practice.

The first period comprises all the attempts to rehabilitate the earlier, distinctly local railroads. It extends down to but does not include the railway failures following the panic of 1857. Railroads were not reorganized in anything like the modern sense; they were merely "set a-going again"; there was no settled and established policy, the failure of each road being treated as an essentially local and individual problem. The second period extends from 1860 to the failures succeeding the railroad panic of 1884. It is characterized by several relatively large reorganizations, in fact it may be said to be separated from the earlier period by the fact that in 1861 and 1862 two of the largest railroad systems had to be reorganized in more than merely local terms.[10] A more closely defined policy was necessary. Railroad reorganization, during this period, ceased to be a matter of merely local interest, and

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[9] Elaborate statistical tables by J. P. Meany, Poor's Manual of Railroads, lxii and cxiii (1900), giving statistics from 1884 to 1899, and Swain, H. H., "Economic Aspects of Railroad Receiverships," 3 Economic Studies, 68 (Am. Ec. Assn. [1898]), giving statistics from 1870 to 1897. The two compilations were by no means identical, but the discrepancies, in terms of the percentage of the country's railroad mileage, were relatively small. Summaries, also, from time to time in the railway journals. 52 Ry. Age Gaz., 945; and 56 Ry. Age Gaz., 4. Crowell (7 Yale Rev., 319) gives certain summaries for the period surrounding the panic of 1873, but does not give sources of his figures. A summary statement is given also in *The Commercial and Financial Chronicle.* 17 Chron., 647; and 22 Chron., 75. Many rough estimates have crept into use, without a clear source. Ripley has made a short summary of railroad failures, drawing his figures largely from the computations of Swain. Ripley, W. Z., Railroads, Finance and Organization, 374 (1915). See particularly the diagram.

Some railroad systems have been conspicuously prone to failure. The following systems have failed and been reorganized three times (omitting from the list roads of merely local significance): The Erie system 1861, 1878, 1895; the old New England Railroad, 1871, 1885, 1895; St. Louis and San Francisco 1876, 1895, 1916; Missouri, Kansas and Texas 1876, 1891, now (1920) awaiting reorganization; Wabash 1877, 1888, 1915; Reading 1883, 1888, 1896; Toledo, St. Louis and Western 1886, 1899, now (1920) awaiting reorganization.

Likewise some managements are conspicuously prolific in failures. Of the various component parts of George Gould's transcontinental railway system all have failed at least once since the blight of Gould management touched them. Those, like the Wabash and Iron Mountain roads, which have been under this management longest have failed the greater number of times.

[10] Pittsburgh, Fort Wayne and Chicago in 1861, and the old New York and Erie in 1862, both about 470 miles in length. For brief history of former see Volume IV, Chapter IV, note 70.

there dawned upon the law and public consciousness the fact that a bankrupt railroad was not to be treated as a private bankrupt estate. The third period extends from 1884 to the panic of 1893. The principles of railroad reorganization as now recognized were being worked out in tentative form during this time. Railroad reorganizations had become matters of public moment. The courts had come to realize fully the social importance of railroad corporations, and their receiverships and reorganizations were supervised in accordance with principles of public policy then being developed in an indirect and cumbersome manner. The fourth period extends from 1893 to 1908. It includes the great railway reorganizations succeeding the receiverships due to the panic of 1893 and the following depression. The principles which were vaguely developed in the preceding period were applied to the rehabilitation of some of the greatest railway systems of the country. The fifth period comprises the latest reorganizations, especially those succeeding the railway failures of 1913 and 1914. These financial readjustments were clear cut and remarkably simple, considering the large mileage of the systems involved, and the intricacies of the financial structures. The fact that these recent railroad reorganizations have been consummated so quickly, so easily, and with so little friction, is an indication that the practice of railroad reorganization has passed its formative periods and has become crystallized.

In a detailed discussion of the five periods outlined above, little need be said of the first. There were many railroad failures during the thirty years from 1827 to 1857, but they were quite as much the failures of promoters as the failures of their railroads. A railroad promoter underestimated the cost of his project. The subscribed capital was insufficient to finish it, and the promoters were forced to sell more stock or more debenture bonds. In being caused by an extension

beyond the available means, these early failures were analogous to those of the later periods, and in the accumulation of a heavy floating debt they resembled their modern counterparts. But there was no recognition on the part of the promoters that they were dealing with a defective financial structure, no conscious intention to remodel the financial plan of the little railroad in accordance with its earnings. Then, too, capital stock predominated in the financial structure,[11] and mortgage bonds having the theoretical right of foreclosure were not issued until the late forties.[12] When the building of the partially completed road came to a standstill for lack of funds, then the promoter, the local merchants and squires, the towns and counties, or other equally restricted groups merely bought more stocks and debenture bonds in order to complete the line. These financial adjustments, even those following the panic of 1837 and the depression extending until 1846, were in no sense reorganizations of financial structures. They were integral parts of the practical working out of railway promotion, episodes in the stupendous and all-absorbing task of substituting steam rail transportation for older and cruder means.

But with the railway failures consequent upon the panic of 1857, a new problem arose. Fully built railroads failed for other reasons than mere unfinished construction. Several

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[11] As late as 1855, after over 17,000 miles of line had been built, the gross funded debt amounted to slightly less than $300,000,000, whereas the share capital amounted to $425,000,000. On this capitalization the railroads were then operating on a 50 per cent ratio, and the net earnings for the year 1855 amounted to over $40,000,000. This was over 12½ per cent on the funded debt. In New England and the southern states, where were located approximately half the mileage—consisting of small locally owned railroads—the net earnings were over $13,000,000, whereas the funded debt was only $72,000,000—earnings of nearly 20 per cent. From this it is apparent that, once built, the railroads were able to meet their fixed charges, so that the later problem of reorganization, as the problem of reducing fixed charges, was not then paramount.

[12] See Volume IV, Chapter IV. At the time of the panic of 1857, mortgage bonds were practically absent from the financial plans of New England and southern railroads. They were comparatively rare among the roads of the middle states, and the exception, rather than the rule, among the roads then built in the western states. (See Volume I, page 42.)

of these failures stand out clearly as analogous, to contemporary railway failures from the point of view of their size and the economic development of rail transportation.[13] We can therefore look upon the treatment of the larger bankrupt railroads following the panic of 1857, as initiating a new era of railroad reorganization finance.

Characteristic of the mental attitude of the men who guided railway finance at the beginning of this period was the reorganization plan used in two important railway failures of the time, the New York and Erie Railroad, the original stem of the present Erie system, and the Pittsburgh, Fort Wayne and Chicago, the western line of the Pennsylvania system.

The old New York and Erie Railroad had been completed in 1851, but had never been prosperous. It suffered severely during the panic of 1857. Low maintenance charges had increased enormously the mere cost of operation, and these difficulties were aggravated by floods and line washouts; the road had suffered from a strike of its engineers, who turned public opinion against the road by reporting that "only boys" were running the trains. Its terminal in Jersey City was unfinished. Its treasurer, the notorious Daniel Drew, had been running competitive steamship lines and otherwise administering the road's treasury to his personal advantage. On the financial side the picture was even more disheartening. Unpaid judgments for over $700,000 were outstanding against the company; it had accumulated a floating and unsecured debt of over $8,000,000, and an old mortgage of $4,000,000 had

[13] The Marietta and Cincinnati Railroad, 180 miles, failed in 1858 and was reorganized in 1860; the St. Louis, Alton and Chicago Railroad, 225 miles, failed in 1859 and reorganized in 1862; the New Albany and Salem Railroad, 292 miles, failed in 1859 and reorganized in 1862; the Great Western Railroad, 170 miles, failed in 1859 and reorganized in 1862; the New York and Erie Railroad, 447 miles, failed in 1859 and reorganized in 1862; the Pittsburgh, Fort Wayne and Chicago Railroad, a consolidation formed in 1856 of three railroads, completed as a line to Chicago in 1858, failed in 1860 and reorganized in 1862. These last two roads were of importance. For brief history of the Fort Wayne road see Volume IV, Chapter IV, note 70. The Erie reorganization is discussed presently.

matured and remained unpaid. The road had defaulted on the interest on all its other bonds—even the interest on the old underlying first mortgage bonds. And capping all these difficulties, the road was earning actually less than its mere operating expenses. The president of the road made a hurried trip to England in the hope of inducing the British security holders to come to the rescue, but the effort was futile. Finally, in the last extremity, receivers were appointed in August, 1859.

At the time of its failure, the affairs of no great railroad system reorganized within recent years were in such despicable condition as those of the old New York and Erie in 1859. It had a notorious celebrity—in financial districts and in the public press. One would presume, therefore, that the reorganization plan adopted to remedy these disheartening conditions would be as drastic and comprehensive as the generally acknowledged reorganization policy of the period would countenance. Yet there was nothing either drastic or comprehensive about the reorganization finally consummated in 1862. The mortgage bondholders were required to make no sacrifices whatever, the small assessment of only 2½ per cent levied on the stockholders being used to meet their overdue coupons. The large floating debt was funded into preferred stock. On the whole, the position of the common stockholders was distinctly stronger, in so far as the menace of a floating debt nearly as large as the common stock[14] had been permanently funded into a type of security having merely a contingent lien on earnings. Although probably the most disheartening failure, all things considered, of a prominent railroad, its reorganization is almost unique in the small amount of sacrifice demanded from any of the security holders.

[14] Prior to the reorganization the floating unsecured debt amounted to $8,500,000 and the common stock to $11,000,000.

In 1875 the Erie Railway failed again, after the panic of 1873. Again it was one of the most severe and far-reaching failures of the time. And again the individual conditions surrounding the failure were almost as disheartening as those of 1859. Nevertheless the reorganization of 1878 was carried out by merely funding into 7 per cent bonds the overdue coupons on certain junior issues of bonds[15] and by levying a small assessment on the stocks.[16] The significant change from the preceding reorganization was the funding of alternate coupons on certain junior bonds, thus to a very limited extent reducing temporarily fixed charges, whereas in the earlier reorganization no effort was made to effect even a temporary reduction in fixed charges. In other words, although both failures were severe, neither reorganization demanded any sacrifice from the security holders at all consonant with the severity of the failure, and the only significant difference between the two reorganizations was that in the one following the panic of 1857 neither a temporary nor permanent reduction in fixed charges was accomplished, whereas in that following the panic of 1873 there was achieved a small temporary, but no permanent lessening of the fixed charges.[17] One astute student of reorganization procedure remarked that "the railroads which failed in the early seventies were not really reorganized—they were simply regalvanized." [18]

[15] The funding of coupons into bonds of the same general tenor was a frequently used method of securing temporary relief from a pressing burden of fixed charges, during the reorganizations of the middle and late seventies and early eighties. It was, for illustration, a prominent feature of the reorganization of the St. Louis, Iron Mountain and Southern in 1878.

[16] The assessments were 4 per cent on the common and 2 per cent on the preferred stocks. But the shareholders could pay, if they wished, half again as much (6 per cent on the common and 3 per cent on the preferred) and receive income bonds for the assessment. Most of the shareholders elected to pay the smaller assessments and receive no securities.

[17] Details covering the failure and reorganization of the New York and Erie are best obtained from Mott, E. H., The Story of Erie, 125 *et seq.* (1901). Daggett, S., Railroad Reorganization, 35 (1908), gives a short epitome, but the account is inadequate to the historical importance of the episode. The details of the second failure and reorganization may be obtained from Mott, E. H., Ibid., and the fuller account in Daggett, S., Ibid., 37-50. Also 21 Chron., 612 (1875); 28 Chron., 67 (1879); 29 Chron., 358 (1879). Also 2 Hepburn Committee Report, 252.

[18] Crowell, J. F., "Railway Receiverships in the United States," 7 Yale Rev., 326 (1898).

The railroad panic of 1884 initiated numerous railway failures. The reorganizations following these failures comprise the third period of our historical review. There were at the time many half-finished railroads, the failure of which was like that of the early railways of the eastern Atlantic states following the panic of 1857;[19] there were other competitive railroads which were built, in fully developed territory, for the single and often avowed purpose of being bought out by stronger rivals, but which were too weak even to initiate the struggle, much less carry it to a successful issue.[20] But fully characteristic of the reorganization policy of the period, as it showed itself in the reorganization of a fully developed and completely articulated railway, was that of the Wabash, St. Louis and Pacific Railway,[21] the antecedent of the present Wabash Railroad. The road failed May, 1884; it was the first of our great American railway systems to

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[19] Types of such failures were the first failure of the Atchison, Topeka and Santa Fé Railway, consequent upon its growth from 2,800 miles in 1884 with net profits of over $7,000,000, to over 7,000 miles in 1888 with net earnings of less than $7,000,000. See Chapter II, note 14, for figures. Of lesser moment, yet of the same character in being failures of unfinished, poorly constructed, half-developed railway systems, located in different parts of the country, were the Denver and Rio Grande Railroad, failed in 1884, reorganized in 1885; the Florida Railway and Navigation Company, failed in 1885, reorganized in 1888; the Houston and Texas Central Railway, and the Houston East and West Texas, both failures in 1885 and reorganized, the former in 1888 and the latter in 1892 (both now important parts of the Southern Pacific's Texas lines.

[20] Two of these buccaneering enterprises did much to bring about and make serious the railroad panic of 1884. The old New York, West Shore and Buffalo was built along the west bank of the Hudson River for no other purpose than to create for itself a "nuisance value" to the Hudson River Railroad. It failed in 1884, with only 475 miles of line but with the enormous capitalization of $40,000,000 of stock and $70,000,000 of bonds. It was reorganized the following year at great sacrifice to the security holders—very unusual for the period. (The first mortgage bondholders were forced to accept 50 per cent in new bonds.) The New York, Chicago and St. Louis Railway was built in the early eighties to parallel the Lake Shore and Michigan Southern Railway. It failed in 1885 and was reorganized in 1887.

[21] The history of this road is illuminating and typical of the growth of our American railway systems. It was formed in 1879 as the consolidation of the old Wabash Railway and the St. Louis, Kansas City and Northern Railway.

The former road, the original Wabash Railway, was reorganized in 1877 out of the Toledo, Wabash and Western Railway. This latter represented a consolidation, in 1865, of the Great Western Railroad, the Toledo and Wabash Railroad, the Quincy and Toledo, and the Illinois and Southern Iowa Railways. The Great Western was a descendant, after failures and reorganizations, of the original Sangamon and Morgan Railroad which was begun by the state of Illinois in 1838.

The other unit of the Wabash, St. Louis and Pacific, the St. Louis, Kansas City and Northern Railway, was a reorganization of the North Missouri Railroad, an enterprise chartered in 1857 to build a line from St. Louis through the northern sections of Missouri to Coatsville on the Iowa line.

throw itself into the hands of receivers.[22] The fundamental reason for this failure was overextension of branch lines.[23] It embraced over 2,000 miles of line, about two-thirds east and a third west of the Mississippi.[24] For a while, the system was operated in two equal parts and the parts emerged from receivership separately,[25] but the reorganization plan, with its successive modifications, contemplated a single unified system. This was necessary in order that the road might weld into a co-ordinated system the heterogeneous mass of independent main lines and foolishly and improvidently constructed branch lines out of which it had been created. There were outstanding at the time fourteen separate issues of divisional first mortgage bonds, bearing interest averaging nearly 7 per cent,[26] and several issues of second, third, and general mortgage bonds bearing 7 per cent interest. Below these senior bonds there were $16,000,000 of general 6 per cent bonds and some $6,000,000 of 6 per cent collateral trust bonds. In addition to all this debt there were $27,000,000 of common stock and $23,000,000 preferred stock.

The first plan of reorganization[27] contained two radical provisions. It required the exchange of the $22,000,000 of

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[22] The significance of this classic case was discussed in some detail in the preceding chapter dealing with reorganization procedure.

[23] This was very clearly stated by the editors of *The Commercial and Financial Chronicle* at the time. The Wabash, St. Louis and Pacific extended its lines very widely in the years 1879 to 1882 by the acquisition of branch and connecting roads, and thereby assumed heavy liabilities. Although the earnings increased largely, the annual liabilities were still far in excess of the net earnings. 46 Chron. Inv. Sup. 2, 130 (March, 1888).

The same opinion was expressed by Swain when he said: "The Wabash, St. Louis and Pacific Railway was one of the most striking illustrations" of a railroad where "the weight of numerous unprofitable branches and extensions has been too much for it." Swain, H. H., "Economic Aspects of Railroad Receiverships," 3 Economic Studies, 84 (Am. Ec. Assn. [Apr., 1898]).

[24] When the Wabash, St. Louis and Pacific Railway failed in 1884 it was then operated by the St. Louis, Iron Mountain and Southern, and the entire system exceeded 3,600 miles. The text above is pertinent to the reorganization of the Wabash, St. Louis and Pacific Railway proper, as the Iron Mountain lease was broken about a month after the receivership, and the leasehold rights on several of the least important western branches were abrogated.

[25] The Wabash Western Railway, including the 641 miles west of the Mississippi River and 362 miles east—1,003 miles in all—emerged from the receivership in March, 1887. The Wabash Railway, including 948 miles east, extending from Toledo to East St. Louis and branches, emerged from receivership in May, 1889.

[26] Eight issues, 7 per cent; 4 issues, 6 per cent; and 2 issues, 5 per cent.

[27] Sept. 1, 1885. Digest, 41 Chron., 30 (1885).

the general and the collateral trust bonds, both bearing 6 per cent fixed interest, into 6 per cent debenture bonds, bearing 6 per cent interest, payable if earned (income bonds). In other words, the road was to be given a temporary "rest." A fixed charge of $1,300,000 was to be changed into a contingent charge. The second radical provision was that the old preferred stockholders were to be assessed 8 per cent a share, the old common stockholders 6 per cent a share (the new income bonds to be given for their assessment), and the old general and collateral trust bonds 2 per cent. In other words, besides having their interest made contingent on earnings, the old junior bondholders were actually assessed. But the reorganization managers were not satisfied with merely a temporary reduction in fixed charges. In a supplementary plan, under the thoroughly justifiable excuse of bringing into a close union and coherent structure all of the Wabash lines, the reorganization managers forced the holders of upwards of nine of the old underlying first mortgage bonds, bearing an average of nearly 7 per cent interest,[28] to accept new 5 per cent bonds issued under a blanket first mortgage. And they forced the holders of the underlying second mortgage bonds, mostly bearing 7 per cent interest, to accept new 5 per cent bonds issued under a blanket second mortgage.[29] In brief, the great Wabash reorganization, a landmark in the history of reorganization practice, not only collected an assessment on stockholders and junior bondholders and made contingent on earnings the interest on two large issues of junior bonds, but it also solidified into two senior blanket mortgages, bearing a low interest rate, practically all the underlying high interest-bearing bonds. Of course, in actual percentages of total charges, the reduction of fixed interest was small and the

[28] Two of these issues, the Toledo and Illinois First 7's and the Lake Erie, Wabash and St. Louis First 7's had been outstanding since 1853.

[29] These second mortgage 5 per cent bonds were further weakened by the fact that foreclosure suit could not be brought until eighteen months after default of interest.

treatment of the junior bondholders who were given income bonds with a mortgage lien was not in any sense drastic. The point of importance is that in this historically important reorganization of a great railway system of the late eighties, there was some permanent as well as temporary reduction in fixed charges and a distinct, although slight sacrifice was required of everyone of the security holders.[30]

The panic of 1893 was prolific in railway failures. And the failures were chiefly, unlike those arising out of the preceding panics, of completed, well-established, and highly organized railway systems. One of the earliest and most conspicuous of these was the failure in the early part of 1894 of the Atchison, Topeka and Santa Fé Railway. The system embraced over 7,000 miles of line and constituted then,

[30] It should not be understood that even this leniency toward security holders, shown in the reorganization of the partly articulated Wabash system, was exercised in the reorganization of the partly finished or "nuisance value" railroads mentioned in notes 19 and 20. On the contrary, the belief in a very wholesome scaling of fixed charges was gradually coming into the consciousness of railroad promoters, though it had not yet reached the understanding of operators of completed systems. In the reorganization of the incompleted Northern Pacific, following the panic of 1873, all the bonds were refunded in a preferred stock. The First Mortgage Bonds in the New York, West Shore and Buffalo reorganization were scaled down 50 per cent. Many instances existed, then as now, in which the bondholders of unfinished or recently promoted railroads were asked to endure drastic sacrifices. This in no wise affects the strength of the generalization that the early reorganization policy for completed going railroads involved little sacrifice on the part of the security holders.

This principle is further illustrated by the two Reading reorganizations of 1882 and 1887. These bring out, with even greater clearness, the leniency of early railroad reorganizations, when one considers that in the fifteen years between 1880 and 1895 the Reading was in the hands of receivers for an aggregate of over ten years. For details of the Reading reorganizations, see the full account in Daggett, S., Railroad Reorganization, Chaps. III and IV (1908). In the reorganization of 1882 the only relief afforded the company was the sale of some senior bonds to fund upwards of $12,000,000 of floating debt. No sacrifices of any kind were demanded of stockholders or bondholders, although the year before the receivership the fixed charges on the debt amounted to $7,500,000 and the net earnings—with inadequate maintenance—to only $5,500,000. In fact the fixed charges were absolutely increased by the reorganization from $7,700,000 to $11,500,000—a net increase of 50 per cent. Daggett, S., Railroad Reorganization, 357 (1908). In the reorganization of 1887, after a receivership of nearly three years, a receivership brought on by fixed charges of over $16,500,000 with net earnings of less than $13,000,000, the remedy adopted was the payment of the floating debt by an issue of new general mortgage bonds.

Nor was there any exception to the rule in the Atchison reorganization of 1888. The interest rates on some branch line bonds covering lines of the system which had failed even to meet operating expenses, were funded into 5 per cent income bonds. The interest on these income bonds was paid and the bonds thereunder soon refunded into second mortgage bonds secured by the entire system and with a definite claim to interest. Considering, therefore, the increase of security given, no real sacrifice was required of any bondholder. For seriousness of the failure, see Chapter II, note 14.

as now, the only single railroad reaching from Chicago to the Pacific Coast. It had been reorganized in 1889, after a period of abnormal and factitious growth, by the refunding of a multitude of small issues of bonds into two blanket issues carrying low fixed charges.[31] But in the intervening years the road had increased its mileage by the acquisition of one railroad after another, without regard for financial expediency or even future solvency. Later, when an independent expert audited the books, he found that there had been an average deficit of over $1,250,000 for the years from 1891 to 1894, notwithstanding the fact that the company had falsified its books so as to represent an ample annual surplus for each year.

The stocks and bonds of the Atchison were largely held in England. Of the bonds there were outstanding $150,000,000 first mortgage 4 per cent bonds and $84,000,000 second mortgage bonds, then carrying 3 per cent interest. The interest charges had not been earned since 1891, according to the independent auditor, and in addition the road had current debts of $11,000,000. But the English bondholders, solicitous of their interests, proposed in an immediate plan of reorganization merely to refund the second mortgage bonds, then carrying 3 per cent fixed interest, into income bonds carrying 5 per cent. The second mortgage bondholders were not to be assessed, and the 5 per cent income bonds offered them were, considering the future as well as the present, quite as valuable as the bonds they surrendered. The stockholders were to be assessed and the proceeds used to pay part of the floating debt and the overdue unpaid coupons on the old bonds. As one writer observes: "The notable part of the scheme was the anxious care of the bondholders to protect themselves." [32] Subsequent realization of

[31] See concluding paragraph of preceding note.
[32] Daggett, S., Railroad Reorganization, 207 (1908).

the seriousness of the failure made the American financial interests realize that the English bondholders' plan was an ineffectual and selfish palliative.

A new, broad reorganization policy was dawning upon the consciousness of both bankers and investors, one which required that a reorganization to be well done must be thoroughly done. And when the final Atchison plan of reorganization was adopted in 1895, it expressed fully an understanding of this new financial wisdom. The old 4 per cent first mortgage bondholders, having a prior lien to the entire system, were forced to accept 75 per cent of the principal in new 4 per cent bonds—a cutting of both principal and interest by 25 per cent. To make up for the loss, they were given 40 per cent in new 4 per cent income bonds. The second mortgage bondholders were required to surrender their bonds for preferred stock, and to pay an assessment of 4 per cent.[33] In other words, they were forced to accept the position of losing partners, not of creditors,[34] in the enterprise. This change from the English bondholders' mild and superficial reorganization plan to that finally adopted by the American financiers, was, in a very true sense, a crucial point in the evolution of our reorganization policy. The former was a makeshift; the latter was a thorough, comprehensive financial readjustment. And the fact that the former was rejected and the latter accepted indicated that a mere palliative with a minimum of sacrifices and a temporary decrease in fixed charges was no longer regarded as a sufficient readjustment to render sound and stable a bankrupt and impoverished railroad system.

The reorganization of the Atchison Railway was among

[33] The statement of the reorganization committee, pointing out the necessity of the drastic sacrifices required of the second mortgage bondholders, has been frequently quoted: "It was not thought that a greater assessment than $10 could be raised from the stock, and the remainder had to come from the junior bonds."

[34] Details of the two Atchison reorganization plans are given in Daggett, S., Railroad Reorganizations, 206, 211 (1908), in which references will be found to the original sources.

the first of the great railroad reorganizations following the panic of 1893. It was prophetic of the new spirit. Already in the Wabash reorganization, outlined above, the new order began to show itself. But in the contrast between the English bondholders' plan and that finally adopted for the Atchison, the contrast between the old and new orders stands clearly defined. It marks the completion of the transition from the third to the fourth period of reorganization policy, outlined in the earlier paragraphs of this chapter. And this means more than an unimportant historical distinction. For the line of demarcation between the great railway reorganizations prior to that of the Atchison in 1895 and those contemporary with it and following it, is more distinct than that between any other of the historical periods.

From the first Erie reorganization down to the English bondholders' Atchison plan, a period of thirty years, there had been a growing realization that a railroad reorganization, to be permanently successful, must be drastic and comprehensive. But this realization was of slow growth.[35] Lawyers stuck to the legal phraseology of bonds and mortgages, insisting that the contractual rights of bondholders must be protected at all hazards, and investors were intolerant and obstructive if forced to submit to anything more than the most superficial and temporary sacrifices.

There were several significant motives to explain the comparative leniency with which bondholders were treated in the reorganizations prior to 1895. All men assumed that the railroad industry was inherently profitable, and would grow

[35] The view here taken, that bondholders were treated more leniently in the earlier reorganizations, is different from the judgment of Meade, who has contended that the position of the bondholder has been stronger since 1893 than before. 17 An. Am. Ac. Pol. Soc. Sci., 232. The view expressed here seems to be in agreement with Crowell. 7 Yale Rev., 319. It is also implied by the exhaustive statistics of Meany, Poor's Manual of Railroads, lxxxix, cvi (1900), and specifically given by Daggett's statistics and suggested by his statements of comparison. Daggett, S., Railroad Reorganization, 358, 363 (1908).

The strength of the position taken here will become more apparent from an examination of the statistics given in the next two chapters.

as the resources of the United States were developed. And this being the case, increasing prosperity might be expected to absorb any ordinary burden of fixed charges which might be placed on a railroad. In many cases it was presumed by overconfident reorganization managers that even an extraordinary burden could be carried, provided drastic competition could be, for the moment, alleviated. Again, the courts showed every inclination to protect the bondholder, should he object to any sacrifice of principal or interest that a stockholder management might wish to impose upon him. By resorting to a variety of legal steps, the bondholders could impede, perhaps frustrate, the reorganization. Further, by no means least important, there was the fact that large proportions of the bonds of our American railroads were held in England and on the Continent.[36] These foreign bondholders acted as a unit against any effort to emasculate their position. They could not be prevailed upon to relinquish any of their literal rights so long as any equity remained to the American stockholders; and the American stockholders refused to relinquish their shadow of an equity because of their inherent confidence in the ultimate prosperity of the railroad industry.[37]

These few historical cases and the generalizations one may draw from them refer to a period of railway finance long since past. Beginning with the crisis of 1893 the motives outlined above ceased to dominate reorganization managers. A new era of financial history dawned, and with it a new policy toward railroad reorganization. No longer were any

[36] After a rapid survey of the railroad receiverships consequent on the panic of 1873, Crowell states: "One hundred and fifty millions, or 15 per cent of the American railway bonds in default at the end of this, the first great crisis in this class of securities, were held in foreign countries, largely in Germany, Holland, and England. This was about 40 per cent of the entire amount of foreign holdings of American railway securities." Crowell, J. F., "Railway Receiverships in the United States," 7 Yale Rev., 324 (1898).

[37] Crowell gives what might be considered another reason, namely, that "many of the mortgages could not be foreclosed at all, because the state had endorsed the bonds and had the right of foreclosure, which it did not exercise because it did not want the road or did not want to sacrifice the property by a forced sale in the midst of financial depression. The state could not be sued on its endorsement." Ibid., 326.

scruples shown in the treatment of the bondholder. Forced by the obvious plight in which the railroads of the country found themselves in the depression from 1893 to 1897, people generally recognized that only through the most drastic cutting of fixed charges, accompanied by large investments of new money, could the bankrupt and impoverished roads be rehabilitated. No longer did the reorganization plans show the dictation of English bondholders who, by delaying their consent, could impede the reorganization; no longer did the courts aid the "striking" bondholders. And, finally—perhaps most prophetic of the new period—men no longer assumed that the railroads would become prosperous, ultimately, no matter what burdens they were compelled to carry.

Many reasons explain the change of opinion. At every period of financial history, those reorganizations consummated at the time of a financial panic or business depression are more drastic than those consummated during a period of business prosperity. Then, too, the influence of the late J. P. Morgan was dominant and worked in every instance for the distribution of sacrifices and the casting of the financial pattern according to actual earnings. But most of all there was a common consciousness that the era of promotion was past and that the restitution of confidence in the industry required that the railroads be given a definite economic stability and their bonds made a secure investment. To accomplish this, sacrifices were required of all who took part in the period of promotion and extension, and permanent protection for those who, in the hour of need, showed their confidence by contributing new money. In attaining these ends the old bondholders were called upon to help. As a result of the drastic reorganizations of this period, the railroads of the country emerged with new life, rehabilitated physically by the investment of new capital, and freed from overburdening debt.

Principles of reorganization practice were thoroughly established by the thoroughgoing and drastic reorganizations of the large railway systems during the middle nineties, and these principles were applied with uniform precision to the recent cases. Omitting, for the purpose of this introductory survey, confusing exceptions and unimportant details, one may summarize contemporary reorganization practice in the following general terms.[38]

So far as the formal procedure is concerned, a reorganization brings about an adjustment—represented usually by a compromise—between the strict construction of the legal obligations of the various security owners and creditors of the road, and the necessity, from the public point of view, that the railroad maintain its service as a solvent, responsible, and progressive corporation. It is the balance between private and public interests. While pretending to hold to the strict construction of the legal contract, the courts have been inclined to allow all interests, no matter what their equitable rights might be, to participate in the reorganization provided an improved railroad service can be promised to the public. Neither state nor federal laws have much to do with determining the character of railroad reorganization. The parties most concerned are encouraged to work out any plan that is expedient and approximately just, provided it is socially and economically sound. And the resulting compromise between the strict rights of the bondholders, the blasted hopes of the stockholders and the welfare of the public, is based on expediency tempered by justice, rather than justice tempered by expediency. It is carried through under the sanction of a system of law which has grown up as a response to the peculiar economic conditions of a new country, a system of

[38] An excellent, readable account of the successive steps in a modern railroad reorganization is given by Lyon, W. H., Corporation Finance, Chap. VIII (1916). His account is neither so general as that of the next few paragraphs, nor so long as that of the next two chapters.

law which has sought to preserve the forms of a legal practice existing long before railroads were conceived, while modifying its substance to meet the actual conditions of railroad success and failure in this country.

As far as the specific results are concerned, the present practice rests, as has been previously suggested, on the elemental principle that two primary ends must be achieved in every railroad reorganization. The more immediate, but less fundamental, is the collection of a fund of money, obtained primarily by a levy on the stockholders, out of which to pay the accumulated debt at the time of the receivership, the improvements of the road during receivership, and the expenses of reorganization; and finally to provide the means that shall keep the reorganized road from incurring new floating debt during the period of its rehabilitation. The second end is the reduction in fixed charges. The letter of the railroad mortgage bond has come to be nothing more than mere legal verbiage, but if the property covered by the mortgage has earned its charges, the mortgage is allowed to remain and the bondholders are not asked to make sacrifices. If, on the other hand, the property behind the mortgage has failed to earn its charges, the bondholders are forced to accept a lessening, perhaps a total extinction, of their rights to demand a fixed income. They may object, but they are powerless to resist, except by acquiring the actual property itself at foreclosure sale; and the failure of their property to earn its charges prior to the receivership gives little promise that its earnings would be better after the bondholders themselves have exercised the letter of their legal rights and acquired by themselves alone the actual operation of the road. We have here another illustration of the fundamental truth that the economic value of physical property is no greater than its inherent earning capacity.

The syndicate of bankers that is called into existence to

finance the reorganization will probably dictate the plan.[39] Normally the plan will provide for the formation of a new corporation which shall take over the assets of the old one, subject to such underlying liens as are not affected by the reorganization. The syndicate is then in a position to issue entirely new securities which are superior to every liability of the old corporation except the undisturbed prior lien bonds. Such new securities are ordinarily of three classes. They may be designated as the fixed charge, the contingent charge, and the common stock securities. The first class will consist of a large issue of general mortgage bonds, having a small interest rate, the aggregate of which is less than the net earnings of the railroad during the receivership. The second class will be income bonds or non-cumulative preferred stock—preferably the latter—the interest or dividend payments of which, together with the interest on the other bonds, will bring the capital charges to an amount somewhat less than the maximum income prior to the receivership. The third class will be the common stock, large in amount, but having no fixed or contingent charge. It is distributed freely in order to placate the old security holders.

The plan will propose as well to secure new money in order to pay the floating debt, the receivers' certificates, and to improve the physical property of the road. This new money will come from two independent sources. A syndicate will purchase of the new corporation a block of the new general mortgage bonds. The holders of the stock and possibly the junior bonds of the old corporation will be taxed or assessed as much as they can be induced to pay for the privilege of acquiring a subordinate interest in the new corporation. This participation is usually represented by a combination of con-

[39] The reader must remember that the next few paragraphs express merely general principles to which all railroad reorganizations more or less conform. The more recent the reorganization, the more nearly it conforms to this type. Nevertheless, exceptions to every one of the following principles abound. Details, variations, and exceptions, when significant, are discussed in the two succeeding chapters.

tingent charge securities and common stock. To assure the new road the proceeds of these assessments, the syndicate which has undertaken to buy a part of the issue of general mortgage bonds will probably agree to pay the assessment demanded of any delinquent stockholder and assume his rights in the new corporation.

The same idea can be restated in the uses to which the three new classes of securities are put. The bonds involving fixed charges are given in exchange for a part or all of those of the old bonds upon which it can justly be claimed that the interest was earned and will be earned under all circumstances. The rest are sold to the syndicate for money. The securities bearing contingent charges, together with the common stock, are given, in varying combinations, to the holders of those old bonds, the interest on which had not been fully earned, and to the stockholders, on condition of the payment of a certain tax or assessment. As a result of these transformations, the almost invariable consequence of every railroad reorganization since 1895 has been that the road emerged from its troubles with a lower fixed charge against income but with a higher total capitalization. The bonds and the fixed interest charges are reduced; but the par value of the preferred and common stocks is increased, by reason of the necessity of distributing these securities freely, in return for the sacrifices made by the old junior bondholders and stockholders. We are thus presented with the striking anomaly that the bankruptcy of a railroad corporation leads to a direct increase of its total issued securities. We are also presented with the even more striking fact that in the presence of financial failure and its consequences the public service character of a railway corporation is brought most clearly into evidence.[40]

[40] The long history of judicial opinion, in which the doctrine of the priority of public over private rights—provided federal constitutional rights are not jeopardized—has been traced many times. It was consciously acknowledged in 1876 (Munn v.

This brief outline of the form of contemporary railroad reorganization is altogether too general and superficial to be of significance when applied to concrete cases. All railroads differ among themselves. The specific causes of railway failure are never the same in two instances, so that the specific remedies to be applied will necessarily vary according to the individual case. Consequently, in order to discuss reorganization plans in any except the most general terms, and to treat of the subject with clearness and definiteness of outline, it is necessary to arrange railroad reorganizations themselves according to some kind of system of classification, else any detailed discussion of the subject degenerates into a mere jargon of unordered cases. But a classification of railway reorganizations is difficult, owing to the extreme difficulty of determining a proper system or scheme.

From all points of view, the most valuable way of classifying railroad reorganizations themselves (and the practical expedients used in accomplishing the two primary ends), is in terms of the causes and extent of the embarrassment which occasioned the necessity of reorganization. In other words, reorganizations are best classified according to their causes. Financial embarrassment, actual or threatened, is the cause of the crisis of which reorganization is the remedy. A reor-

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Ill., 94 U. S. 113) and culminated in the assumption of federal control of the railroads of January 1, 1918. For an exhaustive account, see Ripley, W. Z., Railroads, Rates and Regulation, Chaps. XII to XX (1912).

One or two findings in connection with receivership proceedings are of moment in this connection. As long ago as 1874 the New Jersey Southern Railroad and Long Branch and Sea Shore Railroad were put in the hands of receivers because no daily trains were run for ten consecutive days. These cases present an early discussion of the rights of the public under state law. Among other things the chancellor said: "The Legislature may be presumed to have acted on the assumption that the grant of franchises to a railroad company is primarily to provide a highway for the public, and that there is an implied contract on the part of the company to build, equip and operate their road for the use of the public." In re Long Branch & Sea Shore R.R. Co., 9 C. E. Green, 398, 404. And eighteen years later, in 1892, a receiver was appointed for the Chicago and Southwestern Railway by an Indiana court, merely because certain shippers alleged that the road was unable to care for their business. 32 Chi. Ry. Rev., 479. About this same time Judge Hanford succinctly stated the present attitude of the courts toward railroads, in connection with the Northern Pacific litigation. "A railroad is a public highroad, designed for public use. A corporation owning it enjoys a public franchise which makes it in a measure a public servant, obligated to serve the public by keeping the road in operation." Farmers Loan & Tr. Co. v. Nor. Pac. R. R. Co., 72 Fed. 246 (1896).

ganization, therefore, can be successfully consummated only as it removes the cause, so that any attempt at classification must recognize that the form as well as the concrete details of railway reorganizations will vary according to the nature, extent, and seriousness of the failures which caused them.

There are, in general, three types of railway failures—two pertaining to large railway systems, the third confined to small independent railroads.

The first type, which we will hereafter call "primary failures" and the resulting reorganizations "primary reorganizations," or Class I, is the result of a crisis which is serious, thoroughgoing, and usually long protracted. This class embraces the real financial and economic failures of our large railways. In the actual experience of a particular case, one may assume that the crisis has been coming on for many years. Various palliatives have been applied. Various expedients have been tried; not infrequently some expedient has even approached the scope of a reorganization. Every known device of economy of operation has been tested. Usually the railway system has been overextended into new or competing territory in the hope of increasing the stability of net earnings through increased gross revenue. Ordinarily, every available prop in the way of association and combination has been tried to increase the available net earnings; every known financial device of lease and guaranty, of collateral trust bond, debenture, and short-term note, has probably been resorted to in order to secure money and bolster up a declining credit. All these expedients are at most mere palliatives. They avail nothing. The net earnings continue to decline, the bond interest and rentals increase more rapidly than the earnings. The margin available to the stockholders grows narrower and narrower, and the credit poorer and poorer. Such conditions are fundamental. Yet as the current liabilities of a railroad are always relatively small and its floating debt is, or ought

to be, insignificant compared with its total capitalization, the conditions described may continue for some time before a specific crisis brings about an outward acknowledgment of failure. The important consideration, however, is that the railway system as a whole is a failure economically. Its earning capacity cannot justify its capitalization.

The second class, called hereafter "secondary failures" and the reorganizations "secondary reorganizations," or Class II, embraces those railroad failures which cannot be called fundamental. The earnings, for a few years past, may have fallen off, bad crops, floods, or strikes in the principal industries may have produced conditions seriously affecting the gross receipts, while the operating expenses and fixed charges remained the same; short-term notes or a maturing bond issue may have created financial embarrassment. At all events, a crisis occurs and the railroad's credit cannot withstand it. Failure results. But the causes underlying it are not fundamental. And the remedies that need be applied are neither as comprehensive nor as radical as is necessary with failures of the primary type.

The third type, Class III, pertains to small, unimportant, often unfinished lines of railway. Sometimes the existence of the road was unjustified by the volume of traffic. Sometimes the road was built merely for strategic purposes. Sometimes the road was so grossly overcapitalized and mismanaged, during the construction period, that it became insolvent before it was born. At all events, the railroad is a thoroughgoing failure.[41] But this failure, due to the absence of its obvious public necessity, is not of great economic significance. Its securities are probably closely held and the failure is not confessed until the last phantom of its credit has vanished. In

[41] One little railroad of this type, the St. Louis and Hannibal, was organized in 1872 and the main line opened in 1882. In 1886 the company issued first mortgage 7 per cent bonds, yet has never paid a single coupon from then until now. The road has just been reorganized, through refunding these bonds into common stock.

the restricted and local significance of their undertakings; and in the extent and thoroughness of their distress, the failures of these little local lines resemble the failures of small local industrial enterprises. Failures of this kind are hereafter called those of the third class.

Reorganization plans and expedients follow closely this classification of railway failures. The reorganization of a railway, the failure of which is of the first class, is thorough, comprehensive, and radical. Practically all securities, even small underlying closed first mortgage bond issues, are refunded. And while the holders of these underlying bonds are not ordinarily asked to endure any sacrifices, they are asked to refund their variety of divisional issues into a single comprehensive first mortgage bond issue covering the entire railway system. Ordinarily the interest rate on this single issue is lower than the average rate on the small issues which it refunds, so that it is often necessary to increase the principal or add a complement of junior securities in order to placate these old bondholders. The holders of junior bonds, provided the interest on them can be earned unquestionably, are usually given bonds of a "general" or refunding issue. All other bonds, upon which little or nothing was earned in the years before the failure, are forced to take a preferred stock in the new company. The old preferred and common stocks are assessed, and offered new preferred and common stock. As a result of these changes, a complex financial situation, involving a multitude of small divisional issues, followed by several layers of nondescript bonds, followed in turn by notes and preferred and common shares, is simplified and standardized. There are one or two senior issues of bonds, one issue of preferred stock, and one of common. Considerable amounts of new money are added through stockholders' assessments; the fixed charges are reduced by the refunding of the old underlying and first mortgage bonds into one or two issues

of new low interest-rate bonds, and by refunding the junior bonds into preferred stock. The reorganization, like the failure it follows, is penetrating, drastic, and comprehensive.

Reorganizations following failures of the second class are superficial compared to those described in the previous paragraph. As the failure is not fundamental, a radical readjustment of the financial structure is neither necessary nor advisable. Accordingly, no attempt is made to disturb more than the stocks and junior bonds, and no radical sacrifice is demanded of any security holder. In many cases the whole reorganization turns on the willingness of the holders of some large overlying issue of refunding bonds, notes, or debentures to refund these into preferred stock or income bonds, bearing the same nominal investment return. The charges on the junior bonds become contingent instead of fixed. In return for this sacrifice from the junior bondholders, the stockholders consent to an assessment, receiving in return securities of relatively high value. As a whole, such a reorganization disturbs a comparatively small number of securities, and these are only the uppermost layers of the financial structure. The failure is not serious and a serious remedy is not required.

Reorganizations of railway failures of the third class are exceedingly drastic. The little road has been bolstered up by every conceivable means. Probably when it failed the earnings were actually less than its expenditure. The rolling stock and roadbed are dilapidated. Consequently, relatively large amounts of receivers' certificates are issued immediately, in order to maintain the road in operation. At the time of reorganization, these must be paid. Yet the value remaining to the stockholders is so slight that they will not endure an assessment in order to maintain even their shadow of an equity. As a result, the full brunt of the reorganization falls on the bondholders. Ordinarily there is a single issue of bonds. Accordingly, the holders assess themselves to pay off

the receivers' certificates and to furnish the requisite new money. In effect, they take over the ownership of the road from the old stockholders. In some instances, not only the stockholders' interests are eliminated, but also those of all the bondholders and the road is taken over by the holders of receivers' certificates. In cases of complete failure, the holders of the receivers' certificates may be forced to assess themselves to maintain the operation of the road.

The first of the three types just described stands for serious and fundamental failures of large roads followed by drastic and comprehensive plans of reorganization. The other two types are modifications of this—the second type representing less serious failures followed by merely superficial reorganizations, and the third type the utter failures of small local railways. In view, therefore, of the greater significance and greater intricacy of the first type of railroad reorganizations, the detailed discussions of the next two chapters will be primarily concerned with them.

CHAPTER V

MONEY REQUIREMENTS AT TIME OF RAILROAD REORGANIZATION[1]

Although it is evidently impossible to separate one aspect of the science of railroad reorganization from another, the whole subject is so intricate that, even at the risk of losing coherence and unity, it is much clearer to treat one topic at a time. Nevertheless it must be remembered that the topics covered in this and the succeeding chapter represent one organic whole. The problem of raising capital in any given reorganization cannot be separated from that of reducing fixed charges; the amount of assessments to be levied on stockholders is bound up with the sacrifices of the bondholders. Yet unless some effort is made to separate the various problems involved, a hopeless chaos of half-truths necessarily results. To introduce some kind of order into the subject, the present chapter is restricted to those aspects of railroad reorganization having to do with the immediate means of securing new money; the succeeding chapter concerns itself with the more permanent changes in the form and structure of the financial plan.

[1] This and the succeeding chapter discuss the details of railroad reorganization plans. The two chapters may be omitted by one interested only in a superficial view of the subject such as that given in the closing pages of the preceding chapter. The student of corporation finance should remember that the technical details of current railroad reorganizations present the most complex, intricate, and unorganized and yet the most fascinating subject within the entire field of finance.

In this chapter are discussed the following topics: (1) treatment of floating debt holders, (2) the issue of receivers' certificates, (3) the uses for new money, (4) the sale of treasury assets, (5) assessment on stockholders, (6) reorganization underwriting syndicates.

When a receiver comes into possession of the property of a railroad, he is relieved of the fear of attachments, so that he has the opportunity to make a survey of the obligations standing against his property and to consider carefully the relative priority of the multitude of claims against it. Certain of these obligations must be paid, certain can be postponed, and others may be adjusted and compromised. Ordinarily there is a heterogeneous mass of floating debt[2] of varying dates of maturity, including wage claims and debts owed material men and farmers along the line who have supplied ties. The legal and equitable rights of all these must be settled provisionally.[3] In addition, the question of

[2] In the larger reorganizations of the middle nineties the floating debt was almost always in excess of $10,000,000. Thus the Atchison, Topeka and Santa Fé had at its failure in 1893 over $10,000,000 of floating debt; so also had the Northern Pacific at the time of its failure in the same year. That of the Baltimore and Ohio was over $16,000,000, which amount was augmented by some $10,000,000 before a plan of reorganization was carried through. The floating debt of the Reading at the time of its last failure was estimated at over $25,000,000. Daggett, S., Railroad Reorganization, 139 (1908). Such large amounts as these necessarily represent perplexing problems, especially as the exact status of various parts of the floating debt with respect to each other and the issues of bonds is usually difficult to determine. (In the Norfolk and Western Railroad failure in 1893 there was over $300,000 of wage claims alone remaining unpaid.)

[3] In very rare instances the holders of some or all of the floating debt consent—because of some implied responsibility for the welfare of the company—to accept inferior junior securities, thereby surrendering altogether their rights of priority. The following case is an example of this. The Northern Idaho and Montana Power Company was organized in 1909 by H. M. Byllesby and Company of Chicago, public utility promoters and engineers. It never proved a success because of the fact that the regions of Idaho, Washington, and Montana, which the company served, failed to use its services to an extent commensurate with the amount of capital invested. The company had outstanding $4,614,000 First Mortgage 6 per cent Bonds, upon which interest had not been fully earned for several years prior to January 1, 1917. Before that time H. M. Byllesby and Company, in acknowledgment of their implied moral—but not legal—responsibility for the company had donated to it several hundred thousand dollars, by canceling large amounts of indebtedness due from the company. At the time of the reorganization (plan dated January 2, 1917) H. M. Byllesby and Company and associated interests owned $1,742,500 par value of the First Mortgage Bonds and $517,000 of the floating debt. They agreed to accept preferred and common stock for their bonds, while the remaining bonds, held by the public, were allowed 60 per cent in new First Mortgage Bonds with 20 per cent in new preferred and 35 per cent in new common stock. In other words, the promoters consented to subordinate their bonds to those held by the

priority arises between the floating debt holders and the owners of mortgage bonds and debentures. To adjust all these claims constitutes a very delicate problem, and the general principles to work upon are not clearly defined. The natural assumption, in accordance with the wording of the railroad mortgages, is that the holders of bonds issued under these mortgages have a prior lien on the assets of the bankrupt corporation under all circumstances. But the courts have not so ruled. As far back as 1859, a federal court directed that the receiver meet the claims of employees before paying the interest on bonds.[4] The court alleged the well-being of the public as an excuse. Gradually the same view was extended to other debts incurred in the actual operations of the road, on the ground that in no other way could the road render the required service to the public.

During a series of important decisions,[5] the United States Supreme Court gradually advanced to the formulation of a doctrine since known as the "rule" in Fosdick v. Schall.[6] This rule is based on two rather significant postulates. First there is a distinction made between the fundamental property or capital of the railroad and its current property in the form of current income; and second those current debts contracted

public. In addition they took common stock in liquidation of their floating debt claims, and provided the new company with approximately $500,000 new money by underwriting $522,675 on the new bonds at 88—a price distinctly above what the bonds could command on the open market. The case is remarkable for the sacrifice which the promoters voluntarily endured to protect the public investors and the general credit of the company.

[4] 15 Am. Rd. Jour. 475, 598—Central Ohio, Steubenville, and Indiana case. Until 1878 the courts were inclined to interpret the mortgage instruments according to the strict letter of the law and to give bondholders the priority of lien the letter of their mortgage implied. In more recent years state courts, as a whole, have been stricter in their interpretation than federal courts. See Metcalfe, L. S., Jr., "Priority over Mortgage of Debts Contracted by Railroads before Receiverships," 39 Cent. Law Jour., 241 (1894). For example, as late as 1886 the New York Court of Appeals, in a leading case, would not permit the receiver to place the claims for labor ahead of mortgage bonds. "We are unable to discover any principle upon which the claims of employees for labor performed before the appointment of the receiver can be so extended as to diminish, or impair, or postpone the lien of the mortgage." 103 N. Y. 245 (1886). This view is rare. List of supporting cases cited, 103 N. Y. 246, 247.

[5] 11 Wall. 459 (1870); 91 U. S. 603 (1875); 94 U. S. 798 (1876); 97 U. S. 146 (1877).

[6] Fosdick v. Schall, 99 U. S. 235, decided March, 1878. This leading case will be discussed in the notes immediately following.

to meet imperative operating expenses are distinguished from those contracted for extraordinary expenses and improvements not absolutely necessary to maintain the road's operation. The rule in Fosdick v. Schall permitted a court to insist that its receiver meet all his current expenses during the receivership before he should use any current income to meet the charges on capital—bond interest, rentals, and the like. It also provided that if any of the current income, in the period prior to the receivership, had been deflected from its proper and necessary use of meeting imperative operating expenses, to meet capital charges, then to that extent might the receiver give the necessary operating expenses remaining unpaid a priority over the lien of mortgage bonds.

Since the rule in Fosdick v. Schall was laid down, neither the lower federal courts nor the Supreme Court have shown uniformity in interpreting it.[7] One current of opinion set in toward a total extinction of the presumptive rights of mortgage bondholders, and the other toward the limitation of the priorities of current debts.[8] The whole matter seemed

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[7] As one legal writer expressed it: "The decisions of the federal circuit courts have reflected the uncertainty of the Supreme Court, and the fate of each claim has depended to quite an extent on the ideas of the judge who happened to be sitting in the case."—Dickson, C. A., "Rights of Material and Supply Men in Railroad Foreclosure," 30 Am. Law Rev. 529 (1896).

[8] The first tendency is shown by the Supreme Court in Hale v. Frost, 99 U. S. 389 (1878); Burnham v. Bowen, 111 U. S. 776 (1884); and St. Louis R. R. Co. v. Cleveland Ry. Co., 125 U. S. 658 (1888). In the Burnham case, the acts of a receiver in paying old debts, even though there was no evidence that the corporation had deflected current income to capital charges, was confirmed. Relying on these and similar decisions, certain of the federal courts, charged with the administration of the receiverships of the middle nineties, sought to emasculate entirely the lien of the mortgage bondholders. The extremes are probably represented by Judges Hanford and Caldwell. The former, in the litigation growing out of the Northern Pacific receivership, asserted that "he who takes a mortgage on a railroad does so with the knowledge that the railroad must be operated, and that its earnings must, so far as necessary, be absorbed in the payment of operating expenses." F. L. & T. Co. v. Nor. P. R. R. Co., 71 Fed. 246 (1896). Judge Caldwell in one important opinion (Farmers L. & T. Co. v. Kan. City W. and N. R.R., 53 Fed. 182), went so far as to give practically all current debts a priority over mortgage obligations. He justified his attitude in an address before the Greenleaf Law Club of St. Louis (30 Am. Law Rev., 161) on the ground that there is sometimes collusion between the stockholder management of the railroad and its bondholders, citing the famous Memphis and Little Rock case (20 Fed. 260). Justification for this point of view is argued at length in an elaborate note by Cohn, M. M., 53 Fed. 192. See also Ames v. Union Pac. Ry., 74 Fed. 335 (1896).

The opposite, more conservative current of judicial opinion, has limited the scope of the rule in Fosdick v. Schall. In the Miltenberger case (called by Supreme Court Justice White "a leading case" in 197 U. S. 183), the Supreme Court stated that "the discretion (to give pre-existing debts a priority) should be exercised with very great care," and proceeded to limit specifically the priority of numerous

to turn on a balance between two conflicting sets of motives in the minds of the courts. On the one side are the motives of fairness to labor, small contractors, farmers who supply ties, and such creditors who may not be supposed to investigate the general credit of the railroad, but whose services and supplies must be furnished, regularly and liberally, in order to insure uninterrupted operation.[9] Coupled with this is the imperative public necessity of operation, a necessity which the public character of the railroad business places ahead of the merely private property rights of stockholders and bondholders. On the other side lies the respect which the courts must extend toward contracts, especially those resting on a mortgage of specific property.[10]

In the application of the rule in Fosdick v. Schall to con-

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classes of general creditors. Miltenberger v. Logansport Ry. Co., 106 U. S. 286 (1882). Noting, some eight years later, the extreme liberality with which certain federal court judges were wont to interpret the rule in Fosdick v. Schall, the Supreme Court said: "One holding a mortgage debt upon a railroad has the same right to demand and expect of the court respect for his vested and contracted priority as the holder of a mortgage on a farm or lot. . . . No one is bound to sell to a railroad company or to work for it, and whoever has dealings with a company whose property is mortgaged must be assumed to have dealt with it on the faith of its personal responsibility, and not in expectation of subsequently displacing the priority of its mortgage liens. . . . We emphasize this fact of the sacredness of contract liens for the reason that there seems to be growing an idea that the chancellor, in the exercise of his equitable powers, has unlimited discretion in this matter of the displacement of vested liens." Kneeland v. American Loan & Tr. Co., 136 U. S. 89 (1889). And Chief Justice Fuller stated a little later, "We readily agree that the concession to a mortgagor company of the power through its own act to displace vested liens by unsecured claims is dangerous in the extreme." Quincy Mo. & Pac. R. R. v. Humphreys, 145 U. S. 82 (1891). See also Thompson v. Western Car Co., 149 U. S. 95 (1893); 71 Fed. 29 (1895).

During the time that the rule in Fosdick v. Schall was being interpreted by the courts, many magazine articles, legal notes, and discussions appeared, all concerned with the justice and expediency of superimposing current expense debts over mortgage liens. The best unbiased treatment is Dickson, C. A., "Rights of Material and Supply Men in Railroad Foreclosures," 30 Am. Law Rev. 520 (1896). A less comprehensive treatment with less apparent insight is Metcalfe, L. S., Jr., "Priority Over Mortgage of Debts Contracted by Railroads before Receiverships," 39 Cen. Law Jour., 241 (1894). An early statement, now of little value, is Bispham, G. T., "Rights of Material Men and Employees," 3 Am. Bar Assn. Rep., 167 (1880), which aims to show the danger of the rule in Fosdick v. Schall, then being established. Thompson, S. D., "The Court Management of Railroads," 27 Am. Law Rev., 481 (1893) takes the same point of view in a polemic against the management of railroads by the court. There was an elaborate legal note by Cohn, M. M., covering the subject, 53 Fed. 182. Note also on the subject in St. Louis T. Co. v. Riley, 70 Fed. 32 (1895). A more recent discussion is Ingersoll, H. H., "Rights and Remedies of General Creditors of Mortgaged Railways," 19 Yale Law Jour., 622 (1910).

[9] One legal authority went so far as to call the expenses of operation "a part of the necessary costs of the litigation." High, J. L., A Treatise on the Law of Receivers, 504.

[10] A summary of the present attitude of practicing reorganization attorneys is given in an essay by Byrne, J., in Stetson, F. L., Editor, Some Legal Phases of Corporate Financing, Reorganization and Regulation, 123 (1917).

crete cases, two insistent practical problems are presented: what are necessary operating expenses, and over how long a period before the receivership shall the priority order be extended? A long series of cases decided in the Supreme Court presents somewhat conflicting opinions as to what constitute necessary current operating expenses.[11] In two important decisions the courts have tried to define specifically the current debts that could claim priority. These are the debts for labor, the unpaid balances due connecting roads,[12] and materials for such maintenance as must be "done before the road can be occupied or used," but not for such as is intended "to replace old or worn-out counterparts.[13] In other words, debts for services and materials without which the established routine operation of the road would stop.[14] The other practical question in this connection is the age of the claims. All decisions admit that if a merchandise creditor has allowed his account to remain uncollected for a considerable period, he must be presumed to be depending on the general credit of the road. The debt, no matter of what character, is therefore not entitled to any priority. But the exact period of grace has been left

[11] The Supreme Court has specifically defined current operating debts as "debts not contracted upon the personal credit of the company but to keep the road itself in condition to be used with reasonable safety for the transportation of persons and property, and with the expectation of the parties that it is to be met out of the current receipts of the company." So. Ry. Co. v. Carnegie Steel Co., 176 U. S. 257, 285 (1900). Such current necessary expenses do not now include the costs of betterments, no matter how desirable.

Originally, the rule in Fosdick v. Schall (99 U. S. 235) was worded "necessary operating and managing expenses, proper equipment and useful improvements." But "useful improvements" were subsequently denied in the lower courts. Ill. T. & S. P. v. Doud, 105 Fed. 123 (1900) and R. I. Loc. W. v. C. T. Co., 108 Fed. 5 (1900). And in the Supreme Court, Wood v. Guaranty Tr. Co., 128 U. S. 416 (1888). Even a debt for rails "imperatively required in order that the road may be safely used for transportation of persons and property" was denied priority on the ground that the quantity of rails was so large as to constitute a reconstruction of the road. Lackawanna Iron & Coal Co. v. F. L. T. Co., 176 U. S. 298 (1900). The Supreme Court has even denied the priority of a debt for new ties to replace decayed ties, on the ground that the road could somehow operate with the old ties. Gregg v. Metro. Tr. Co., 197 U. S. 183 (1905). It should be noted, however, that this latter case has the force of this extreme position somewhat weakened by the dissent of three of the justices on the ground of public policy.

[12] Miltenberger v. Logansport Ry. Co., 106 U. S. 286 (1882).

[13] Clev. C. & S. v. Knickerbocker Tr. Co., 86 Fed. 73 (1898).

[14] For more extended discussion of the preferred claims in the various cases mentioned in the three preceding notes, see particularly the Miltenberger and Gregg cases, cited above. The strict and liberal interpretations are clearly contrasted in the prevailing and dissenting opinions of the latter case. See also Machen, A. W., Jr., Modern Law of Corporations, 564 (1908).

to the judges of the federal courts appointing the receivers, and the Supreme Court has confirmed their decisions whenever the particular facts show them to have been reasonable and just.[15] A period of six months has been explicitly approved by the Supreme Court in a comparatively recent decision[16] and has been quite generally adopted as a working principle by the federal courts of the East and Middle West.[17]

Although the receiver may determine that, from every motive of law, justice, and expediency, it is wise to pay immediately certain current debts of the railroad, he cannot move unless he secures the funds. Ordinarily, too, the physical condition of the road is such as to demand immediate expenditures for betterments and neglected maintenance in order to insure the safe and economical operation of the trains. Beset with these demands, the receiver of a bankrupt railroad ordinarily considers the procuring of money as the first step in his administration of the property.[18]

This is difficult. The road probably has mortgages on the most valuable parts of the line. Every expedient for raising new money has been resorted to by the management in the period prior to the receivership. And the receivership itself has further depressed an already low general credit. Current bond interest can be deflected to the payment of cur-

[15] It is impossible to state definitely any arbitrary rule. In one case the Supreme Court approved a limit of three months. Miltenberger v. Logansport Ry. Co., 106 U. S. 286 (1882). Justice White later called this the leading case dealing with the preference of different claimants (197 U. S. 183, 193), while another court allowed a debt of nearly two years to have preference over the bonded debt. Atkins v. Ry. Co., 3 Hughes C. C. 307. See also N. P. R. R. v. Lamont, 69 Fed. 23 (1895). Note on time fixed in different decisions prior to 1884, 22 Fed. 476.

[16] Gregg v. Metro. Tr. Co., 197 U. S. 183 (1905).

[17] See note, High, J. L., A Treatise on the Law of Receivers, 512, stating courts which have and which have not accepted the six months' limit. The "six months' rule" is accepted by eastern state courts. For example, "the usual rule is to allow prior claims for materials and labor for the six months preceding the appointment of a receiver." Rutherford v. Penn. Mid. R. R., 178 Penn. 38 (1896). Judge Caldwell asserted explicitly there was no six months' limit. Farmers' Loan & Tr. Co. v. Kan. City Ry. Co., 53 Fed. 182 (1892). The Supreme Court has stated that the six months' rule did justice ordinarily, but that older claims might be given priority in unusual circumstances. Sou. Ry. Co. v. Carnegie Steel Co., 176 U. S. 285 (1900).

[18] See previous brief discussion, Volume I, pages 68 and 69.

rent operation charges and improvements, but this is ordinarily insufficient. The receiver must, therefore, find new sources of money quickly in order to meet the public demands of a safe and efficient railway service.

This new money is ordinarily obtained through the issue of receivers' certificates. This form of security came into existence less than fifty years ago.[19] It owed its origin to the extreme difficulty encountered by a receiver of an impoverished road in securing the money required to keep the road in operation. He could not borrow on the credit of the road nor extract money from stockholders. In such extreme cases the courts permitted their receivers to borrow on the credit of the "whole estate" within the control of the court. And from these extreme cases the practice has been extended until it has become the custom for courts to allow their receivers to issue receivers' certificates which take precedence over the pre-existing claims of general creditors[20] or even of the mortgage bondholders.[21]

The legal or statutory authority under which the receiver

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[19] Brief outline of origin, Cleveland and Powell, Railroad Finance, 243 (1912); also Carr, W. A., Receivers' Certificates, 1 Penn. Law Series, 593 (1895).

[20] Receivers' certificates may even be given priority over the claims for current operating expenses under the rule in Fosdick v. Schall. Bank of Commerce v. Cent. Coal & C. Co., 115 Fed. 878 (1902).

[21] The priority of the certificates, unless expressly limited by the court, reaches under any debts contracted by the road. See 13 Atl. Rep. 271; also Ames v. Union Pac. Ry., 74 Fed. 335 (1896). But if the receiver was appointed at the request of certain junior mortgage bondholders, he would not ordinarily be permitted to issue receivers' certificates which take precedence over the pre-existing claims of general creditors or even of mortgage bondholders. See a series of discussions in the federal courts, by no means uniform, 54 Fed. 556 (1893); 62 Fed. 771 (1894); 71 Fed. 776 (1896); 79 Fed. 196 (1897); 102 Fed. 382 (1900). The matter is by no means clear, as a liberal interpretation of the priority of operating expenses —even before the receivership—as laid down by the Supreme Court in the rule in Fosdick v. Schall, and interpreted in the Illinois Midland case (Union Tr. Co. v. Ill. Midland R.R. Co., 117 U. S. 434 [1886]) would seem to give the court unlimited power in the issue of receivers' certificates. Also Amer. Tr. Co. v. Metro. S. S. Co., 183 Fed. 250 (1910); and 190 Fed. 113 (1911); Atl. Tr. Co. v. Chapman, 208 U. S. 360 (1908). In actual practice, the court tries to be precise in defining the priority of the receivers' certificates it authorizes. In the famous Wabash case (failure of 1884) the court sought to distinguish between the lien of receivers' certificates issued to pay "back claims against the body of the property" and those issued for general reconstruction purposes. (See 38 Chron., 731, 754). For references to a number of instances of liberal use of receivers' certificates, see Cleveland and Powell, Railroad Finance, 243 (1912). See also the standard legal treatises on receivers: High, Smith, Beach, etc. Also Hardy, C. A., "The Power of a Court of Equity to Authorize the Issue of Receivers' Certificates," 44 Cent. Law Jour., 344 (1897).

acts in issuing his certificates is by no means clear. In ordinary practice a receiver asks of the court permission to issue certificates. In this petition he must designate in considerable detail the purposes for which he wishes to use the proceeds obtained from their sale; yet the general purposes for which receivers' certificates may be issued have never been precisely defined by the courts.[22] But it may be said that the courts are willing to permit the receiver to issue his certificates without much question and to any reasonable amount, if it appears that the interest and principal can be met from the current earnings of the road, or if the bondholders consent to their issue.[23] Certificates may even be issued if they infringe on the actual capital of the railroad property—even to the point of cutting under prior lien mortgages[24]—provided it is necessary to obtain money for the preservation and operation of the property.[25] They may also be issued to meet the debts for labor and necessary materials during the period just prior to the receivership,[26] although such certificates may not have the same

[22] The mere appointment of the receiver does not empower him with the court's authority to borrow on receivers' certificates. Nor does the assumption by the receiver that the court will permit him to borrow give the borrowings a priority over other forms of indebtedness. For discussions see the leading Illinois Midland case, 117 U. S. 434 (1886), and other cases cited in preceding note.

[23] Rutherford v. Penn. Midland R.R., 178 Penn. 38 (1896). The Pennsylvania Supreme Court permitted issue of receivers' certificates to complete a line at "the request of a very large proportion of bondholders, and without prejudice to the non-assenting."

[24] Leading case Wallace v. Loomis, 97 U. S. 146 (1878); Union Tr. Co. v. Ill. Midland R.R. Co., 117 U. S. 434 (1886). For comments on this doctrine see Kneeland v. Am. Loan & Tr. Co., 136 U. S. 89 (1889).

[25] On November 2, 1917, the bondholders' committee of the Gulf, Florida and Alabama Railway urged the depositing bondholders to accept a drastic reorganization plan which revealed an interesting case of the gradual emasculation of the bondholders' lien by a receiver. It appeared that $500,000 of receivers' certificates had been given by the court a lien ahead of $4,000,000 first mortgage bonds. "Of these only $222,500 had actually been sold and the proceeds used largely to satisfy lien claims incurred previous to the receivership, and for operating deficits." The remainder could not be sold, and there was an operating deficit of $10,000 per month; "so that a debt is piling up prior to the bonds which must be stopped at once to preserve any value in the bonds."

[26] Union Tr. Co. v. Ill. Midland R.R. Co., 117 U. S. 434 (1886). Apparently the court must be convinced that the materials and services are required for the actual operation—necessary operating expenses as defined in the earlier part of this chapter (Rogers B. C. Co. v. Omaha K. C. E. R.R., 154 Fed. 629 [1907]), and would frown upon allowing the expenses of extraordinary replacements and betterments to be paid out of the proceeds of receivers' certificates. It should be noted, however, that the distinction will depend upon the theories of railroad accounting and the standards of operating efficiency adopted by the courts.

priority as those issued to pay the debts of the receivership.[27] When this liberality of issue is carried to an extreme, courts of equity may so burden a railroad with receivers' certificates that the value of the mortgage bondholders' lien is absolutely obliterated. This is exactly what has happened in several recent instances in which the bondholders have had nothing of real value left when the time came to discharge the receiver.[28] It is this power of the courts of equity, supported by a series of Supreme Court decisions,[29] that jeopardizes both the spirit and the letter of railroad mortgages. The possible exercise of this power by the federal courts weakens every public utility bond. It has been called the "extreme limit of the most extraordinary powers of a court of chancery."[30] Quite so, and one might call it an unjustifiable emasculation of the substance of presumably inviolable contracts.

During the period of receivership, the court under which the receiver administers his trust provides the funds required for improvements and operation, either through the deflection of current income or through the issue of receivers' certificates. The real problem arises, however, when the time comes to put into effect some plan of reorganization. No longer is it possible to borrow on the authority of the court through the issue of receivers' certificates. So that any comprehensive plan of reorganization involves the raising of a considerable sum of money.

New money is ordinarily required at the time of reorganization for five separate purposes: (1) The accumulated floating debt must be paid off or else be adjusted. If an adjustment is made with the creditors, it is always effected

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[27] B. of C. v. Cent. C. & C. Co., 115 Fed. 878.

[28] See note 25, for extreme case.

[29] Am. B. Co. v. Heidelbach, 94 U. S. 798 (1876); Wallace v. Loomis, 97 U. S. 146 (1877); Fosdick v. Schall, 99 U. S. 235 (1879); Swann v. Clark, 110 U. S. 602 (1883); Union Tr. Co. v. Ill. Midland R.R. Co., 117 U. S. 434 (1885).

[30] Machen, A. W., Jr., A Treatise on the Modern Law of Corporations (1908).

on the basis of some compromise involving a considerable money payment. In case this floating debt has already been funded into receivers' certificates, these must be paid off with new money in the same way as if the receivers' certificates had been issued to pay for the operation and improvements of the road during the receivership. (2) Money must be supplied to pay off the debts contracted during the receivership. These debts may have been incurred in order to meet the current expenses of operation, or they may have been incurred for the purpose of improving the railroad property. It has been noted already in connection with the issue of receivers' certificates that enormous amounts of money are often expended by the receiver for the improvement of the road. As the benefits of these improvements pass on to the new corporation, it may justly be compelled to meet them out of the fund supplied to it at the time of reorganization. (3) Money is required to meet the direct expenses incident to the reorganization and the receivership. These are often heavy. Sometimes the court has appointed a prominent politician receiver, and the reorganization committees must tolerate an extortionate toll before he will release his grip. There may be a host of parasites—members of the reorganization committees who have done nothing, masters who have taken testimony, attorneys who have rendered merely nominal services—that must be paid off before the new corporation can acquire the assets of the old. There are, too, many legitimate expenses—printing, postage, court fees—which tend to swell the amount. (4) Though the underlying liens are not disturbed, so that no new money is required to care for them, one or more of the junior liens is usually foreclosed, and money must be provided with which to pay off the holders who do not deposit their bonds under the reorganization plan.[31] (5) The new corporation must be provided with some work-

[31] This matter is discussed in detail with special reference to the Pere Marquette reorganization. Chapter VI, note 7. See also Chapter III, note 67.

ing capital. While ordinarily the property is delivered over by the receivers in a better condition than when they assumed control,[32] the new corporation must have means to carry forward ordinary improvements, without borrowing, during the period of rehabilitation. This is especially important as the new corporation, but recently emerged from the receivership, would be able to sell its securities only at a prohibitive discount.

These various purposes require in the aggregate a very large amount of actual money. This can be provided in a few rare instances by the sale of securities or other assets remaining in the treasury of the old corporation. Ordinarily, however, it must be subscribed by the various parties concerned in the permanent welfare of the railroad. Various methods are used for getting this money. These are described in some detail in the succeeding parts of this chapter.[33]

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[32] This may not be due to skill on the part of the receivers. It is due rather to the power of the receivers to issue and sell their certificates on the credit of the court's sanction. As a result many improvements in roadbed and equipments are made which could not have been financed under the impoverished credit of the old management. Many instances exist, however, in which the receiver shows greater managing ability than the old management. This is quite often true in the case of the receivership of small railroads.

[33] The disposition of the money obtained at the time of a drastic reorganization of a small, thoroughly unsuccessful railroad representative of Class III, as described in closing sections of preceding chapter, is shown by the following table. This particular reorganization is noted—perhaps notorious—because of the fact that money was not raised to pay the receivers' certificates; in fact the cash requirements of the reorganization were kept as small as possible.

DISPOSITION OF PROCEEDS OF SALE OF STOCK

(Common stock of reorganized company at $12 a share)

Obligations of receiver for equipment acquired during receivership, tax loans, claims and judgments, interest, etc.	$1,105,491.52
To retire outstanding equipment obligations issued prior to receivership, with interest	930,237.50
Legal expenses of counsel for trustees in the foreclosure of the railroad and two terminal company mortgages, and the sales thereunder	66,000.00
Reorganization expenses, including trustee's fees and disbursements, partly estimated	185,224.93
Compensation and expenses of receivers' certificates committee in connection with the purchase and management of the properties, the organization of the new company, the negotiation of the underwriting, etc.	84,546.05
Compensation which may be allowed by the court to the receiver and his counsel	112,500.00
Commission to syndicate managers and underwriting syndicate	216,000.00
To treasury of new company for working capital, improvements and repair of equipment ($288,000)	900,000.00
Total	$3,600,000.00

Reorganization plan of the Atlanta, Birmingham and Atlantic Railroad, dated December 15, 1915, page 5.

The simplest method conceivable which a railroad in the process of reorganization may employ to raise money, is the sale of securities in its treasury. If the railroad has securities of other corporations in its treasury previously held for investment these can usually be sold for money[34] because its own embarrassment has not affected their value; or if it has preserved for itself certain valuable privileges these may be sold to other corporations.[35] But instances of this kind are rare, as a bankrupt railroad will probably have used up all such means of securing money long before its receivership. A sale of its own securities is ordinarily difficult, as any prior lien or underlying first mortgage bonds will probably have been sold long before the crisis. A widening knowledge of the troubles of the road makes impossible the sale of any junior or inferior bonds except at a prohibitive price.[36] Nor can stock, quoted perhaps at less than $10 a share, be sold to yield any considerable amount of money.[37] The success of a few rare instances in the past, in which a sale of the

[34] As in 1898 the Baltimore and Ohio sold approximately $3,800,000 Western Union Telegraph stocks to a syndicate for about 90 per cent. Daggett, S., Railroad Reorganization, 27 (1908).

[35] Thus in 1887 the Baltimore and Ohio Railroad, when temporarily embarrassed, sold its express business for $1,500,000 in the readily marketable stock of the United States Express Company, its telegraph business to the Western Union Telegraph Company for $5,000,000 of the latter's stock; and, in the following year, its sleeping car business to the Pullman Company for over $1,000,000 in money. Daggett, S., Railroad Reorganization, 14 (1908).

[36] A few illustrations from early and recent railroad history show the straits into which a railroad may be driven just before a crisis. Eight million dollars of 7 per cent Convertible Gold Bonds were sold by the Erie Railway—several years before the receivership of 1875 and in the midst of a panic—to Bischoffscheim and Goldschmidt of London so as to net the road after payment of commissions "etc.," $4,249,989—and to accomplish this the earnings for the first year had to be fraudulently inflated so as to permit the declaration of dividends on the preferred and common stocks. Mott, E. H., Story of Erie, 232 (1901). The Reorganization Committee of the Atchison discovered that during the five years prior to the receivership of 1895, the management had paid out more than $1,000,000 for discounts and commissions on less than $10,000,000 of "guarantee fund notes," issued originally in 1888 as purely an emergency measure. McLeod was paying more than 10 per cent in order to carry his ill-advised purchases of stock in the years just before the Reading receivership of 1893. Immediately before its receivership in 1915 the Missouri, Kansas and Texas Railway was paying upwards of 10 per cent on its accumulating floating indebtedness. Volume IV, Chapter VII, note 7.

[37] Once in a while when the general financial conditions have been particularly auspicious, it has been possible for an embarrassed railroad to sell sufficient junior securities to fund its floating debt. Contrary to all the canons of sound finance, President Gowen planned to bring the old Philadelphia and Reading Railroad out of its second receivership by the sale of an anomalous bond, junior to the common stock, at 30 per cent of its par value, and of certain other bonds in the treasury. But the revenue of the road was equal to its fixed charges at the time and its

junior securities of a bankrupt railroad has relieved a crisis, are too individual to vitiate the generalization that such sales cannot be relied upon to secure sufficient money to effect a permanent rehabilitation of the road. A railroad in the presence of a financial crisis cannot rely on mere palliatives.

It was pointed out in the preceding chapter that every railroad reorganization turns about two central points—the procuring of new money and the reduction of fixed charges. We have already observed, in this chapter, that receivers' certificates although issued and sold in large amounts without difficulty during the receivership, are not capable of furnishing any new money that can be brought into the permanent capital of the road. The court will, almost invariably, require their payment in money as a condition of the termination of the receivership.[38] They are merely temporary expedients. Similarly little or no reliance can be placed on the sale of miscellaneous securities and junior bonds and stocks from the treasury of the bankrupt road. Two and only two ways remain to secure resources that can remain as part of the permanent capital of the road—either the forced payments from the old security holders, or voluntary subscription by bankers and investors. The former represent the contributions or assessments levied on the old security holders as a condition of participation in the ownership of the new company. The latter represent the sale of valuable securities to underwriting syndicates.

The use and importance of assessments on old security

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senior bonds had a relatively high credit. Daggett, S., Railroad Reorganization, 355 (1908).

Just before the failure of the second St. Louis and San Francisco Railroad in 1913 bankers closely associated with the road had sold junior bonds; but the representations said to have been made at the time of the sale were creditable to neither the bankers nor the officials of the road.

For the year 1911-12 the Georgia and Florida Railway had a deficit of $320,000 —the previous year a surplus of $30,000. To try to ward off a receivership, the common and preferred stockholders purchased 6 per cent General Mortgage Bonds of the company at 52. Such a proceeding is unusual at the present time.

[38] Of course this is not invariably true. See Volume I, pages 68 and 69.

holders has steadily increased since the reorganizations of the period following the panic of 1873.[39] They are in accord with the general tendency to impose drastic sacrifices on the holders of the old securities as the price that enables them to preserve the shadow of their equity.[40]

These assessments arise from the necessities of the road, and their distribution among the different classes of security holders is, unfortunately, treated much more as a problem of expediency than of justice. The fundamental economic and legal distinction between the stockholder and the bondholder is usually forgotten, and it is growing more and more to be the practice of railroad reorganizations to look at the position of all the classes of junior security holders as differing among themselves only in degree and not in kind. And while it is recognized that the common shareholders ought to suffer most in reorganization, the members of the committee are concerned more with securing the required amount of money, somehow, than with meting out justice in accordance with a more or less obsolete distinction between owner and creditor. The second Atchison reorganization marked the transition

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[39] Daggett concludes from the cases examined by him that assessments were more frequent after the panic of 1893 than before. Daggett, S., Railroad Reorganization, 351 (1908). This would seem to be borne out by the presumption that the later reorganizations were more drastic than the earlier ones. On the other hand, the statistics of the 57 reorganizations between 1884 and 1899, gathered by Meany, do not seem to support this belief. Of the 57, 17 plans were announced prior to January 1, 1894. Of these, 13, or 77 per cent, involved assessments on either or both stocks and bonds; of the 40 plans announced after 1894, 25 involved assessments, or 62½ per cent. Poor's Manual of Railroads (1900). The writer believes that the generalization of Daggett is correct; and that the opposite conclusion to be drawn from Meany's statistics is due to the fact that he included many small financial readjustments. Many students of the subject, by a confidence in mere ungraded statistics, do not give sufficient attention to the distinction between large and small reorganizations, and the individual conditions of the preceding failure. Certain it is that not a single important railroad reorganization has occurred from 1893 down to the assumption of federal control that has not been predicated on a considerable money payment by the security holders. Tables giving assessments in recent reorganizations are given later. See page 113.

[40] This idea has required a good deal of time to penetrate the financial consciousness. For historical illustration, certain London and Amsterdam stockholders of the old Denver and Rio Grande objected to an assessment of $8, as far back as 1885. The editor of *The Commercial and Financial Chronicle* remarked: "The stockholders of American railroads have got to face the fact that they have no rights as against mortgage bondholders; and further, that they (the stockholders) by their management of the company are the parties responsible for the kite-flying, ill-judged extensions, and the payments of dividends, which usually bring the property to bankruptcy." 41 Chron., 76 (July 18, 1885).

from the old theories of reorganization to the new,[41] and this very point is excellently illustrated by a circular sent to the junior bondholders at the time. After stating that the amount of money to be raised amounted to $14,000,000, the reorganization committee went on to say: "The stockholders in the ordinary course should provide the whole of this amount . . . but the proportion of the assessment that would be borne by the stockholders could only be gauged by the amount of assessment that they would be willing to pay in order to protect their rights. This amount is believed to be $10 per share, and it is necessary that the second mortgage bondholders shall provide the remaining $4 for their own protection."

This statement embodies the theory of allotment of assessments now universally followed by railroad reorganization managers. The amount of money required is first determined from the reports of the engineers, traffic experts, attorneys, and receivers. The amount of assessment which the common stockholders will stand is then estimated by the bankers, their judgment being guided by both the current market price of the common stock and the probable market price of the new preferred and common shares which the reorganization managers propose to allot to the common stock. The same processes of reasoning are applied to the old preferred stock. If the amounts which the two classes of stock are probably willing to pay in order to retain an interest in the reorganized railroad are not equal to the amount which must be raised from the security holders, then the remainder is assessed against the junior bondholders. Entirely practical questions fix the relative amounts of assessments. How much does the road need and how much can be drawn out of each class of security holders and how little given in return? In accord with this principle, based on expediency and not on justice, the assessments on the stocks of roads passing through a

[41] This matter was discussed at some length in Chapter IV.

serious crisis, (Class I, as described at the close of the preceding chapter) are smaller than those on roads suffering from a temporary embarrassment—reorganizations of Class II. The stockholders have less at stake in the former case and can therefore be counted on to contribute less.

In the reorganization of the Pere Marquette of 1916, illustrative of Class I, these principles are exactly portrayed. In order to secure the requisite amount of money, not only were the three classes of stock required to pay an assessment, but the two classes of junior bondholders were also called upon as well. A preferred stock was offered for the assessment, and only a small bonus of common stock. Under these circumstances, the common and even the preferred stockholders would be willing to pay only a small assessment. It was fixed at 9¾ per cent. Moreover, since little or no value remained to the equity of the junior bondholders, no distinction was made between any of the junior securities. The reorganization managers considered them all equally bad. And if the assessment was placed as low as 9¾ per cent, the full requirement of new money could be obtained only as the two outermost layers of junior bonds paid the full assessment, just as if they had been common and preferred stockholders.

In the recent comprehensive reorganization of the St. Louis and San Francisco, a somewhat different means was taken. A valuable security, general first mortgage bond (the same issue as that into which the underlying bonds were refunded and a part of the same issue that was sold to an underwriting syndicate), was offered to the stockholders for their assessments. Under these circumstances the payment of a large assessment could be counted on, especially as a liberal bonus of common stock was offered with the bonds. Accordingly, the assessment was made 50 per cent, but arrangements were made at the same time to enable stockholders to sell their new bonds so as to reduce the actual assessment to a small sum.

In reorganizations of Class II, those following temporary embarrassment rather than serious failure, the assessments to the stockholders are consistently large. As already pointed out, the expediency of these heavy assessments is based on the presumption that, since the equity remaining to the stockholders is large, they will endure a large assessment in order to preserve it. And, again, because the railroad property has a value well above the bonded debt, the new securities offered in exchange for the assessments and the bonus of common stock can be made very liberal.

The following table illustrates these principles.

ASSESSMENTS IN IMPORTANT REORGANIZATIONS (1910-1919)

Railroad	Old Security Assessed	Amount of Assessment (per cent)	Amount of New Security Given for Assessment (per cent)	Kind of New Security Given for Assessment	Common Stock Bonus (per cent of par of old security)
Reorganizations of Class I					
Pere Marquette	Collateral Trust Notes	9¾%	10%	1st Pfd. Stk.	20%
	Debentures	9¾	10	"	20
	1st Pfd.	9¾	10	"	20
	2d Pfd.	9¾	10	"	20
	Common	9¾	10	"	20
St. Louis & San Francisco	1st Pfd.	50	50	Prior Lien Bonds	100
	2d Pfd.	50	50	"	90
	Common	50	50	"	82
Reorganizations of Class II					
Missouri Pacific	Common	50	50	Gen. Mort. Bonds	100
Rock Island	Common	40	40	Pfd. Stk.	100
Wabash	Pfd.	30	50	1st Pfd. Stk.	50
	Common	30	50	"	45
Western Maryland (voluntary)	Pfd.	30	30	1st Pfd.	100 (in 2d Pfd.)
Wheeling & Lake Erie	Common	30	30	1st Pfd.	100
	1st Pfd.	27	27	Pfd. Stk.	100
	2d Pfd.	27	27	"	90
	Common	27	27	"	87½

Taking these important reorganizations as a whole, it appears that the following conclusions may be drawn:

1. In no case was there a difference in the rate of assessment for different classes of securities in a reorganization.

2. The average rate was approximately 34 per cent, averaging each reorganization as a unit, and a trifle less than 30 per cent, if each assessed security is considered a unit. With the low assessment on the Pere Marquette securities omitted the average was 40 per cent by either way of computing it.

3. In cases where more than one class of security was assessed in the same reorganization, the security given for the assessment was the same for each class assessed.[42]

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[42] Were we to compare these reorganization assessments with those of the earlier reorganizations, we should find certain striking differences. In the first place, these assessments are larger; more money is now secured at the time of reorganization than was once. Formerly, especially in the reorganizations preceding the panic of 1893, a painstaking effort was always made to apportion the burden of assessments more nearly upon the relative position of the stocks. The common stockholder was usually asked to pay more than the preferred, on the assumption that the burden should rest more heavily on those who would reap the largest benefit from pronounced success. The amount and the character of the assessments in the older reorganizations can well be illustrated from a series of tables of important reorganizations at different periods of financial history. The lists are in no sense exhaustive, although it is believed that the tables cover a fair random selection of important reorganizations.

TABLE 1—EARLY REORGANIZATIONS

Railroad	Date	Old Security Assessed	Amount of Assessment (per cent)	Amount of New Security Given for Assessment (per cent)	Kind of New Security Given for Assessment
New York & Erie (Erie)..	1862	Preferred	2½%	None	None
		Common	2½	None	None
Erie Railway...........	1877	Preferred	2	None	None
		Common	4	None	None
		or			
		Preferred	3	3%	Income Bonds
		Common	6	6	Income Bonds
Denver & Rio Grande....	1885	Common	8		
East Tennessee..........	1886	Income Bonds	5	5	1st Pfd. Stock
		Common	6	6	2d Pfd. Stock
Reading................	1886	Income Bonds	2½	2½	Pfd. Stock
		Preferred	10	10	"
		Common	10	10	"
Pittsburgh & Western....	1887	Common	4	8	Pfd. Stock
New York, Chicago & St. Louis................	1887	Preferred	10	10	1st Preferred
		Common	10	10	"
Iowa Central...........	1888	Debentures	2½	2½	Debentures
		1st Preferred	5	5	"
		2d Preferred	10	10	"
		Common	15	15	"

Average assessment on preferred stocks.... 5 per cent
" " " common stocks..... 7.5 " "
" " " stocks............ 6.3 " "
Assessments on bonds unusual in reorganizations of Classes I and II.

In any reorganization, the practical determination of the amount of an assessment is a matter of great moment. It

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TABLE 2—IMPORTANT REORGANIZATIONS OF THE MIDDLE NINETIES

Railroad	Old Security Assessed	Amount of Assessment (per cent)	Amount of New Security Given for Assessment (per cent)	Kind of New Security Given for Assessment
Northern Pacific	Preferred	10%		
	Common	15		
Richmond Terminal	Common	10	2½%	Bonds
			7½	Preferred Stock
Erie (N. Y., L. E. & W.)	Preferred	8		
	Common	12		
Baltimore & Ohio	1st Preferred	2	2	Preferred Stock
	2d Preferred	20	20	"
	Common	20	20	"
Atchison	Second Mortgage and Income	4	4	Preferred Stock
	Common	10	10	"
Reading	Deferred Income Bonds	4		No Special Securities for Assessments
	1st, 2d, 3d Income Bonds	20		
	Common	20		
East Tennessee, Virginia & Georgia	1st Preferred	3	.75	Bonds
			17.25	Preferred Stock
	2d Preferred	6	1.5	Bonds
			4.5	Preferred Stock
	Common	7.2	1.8	Bonds
			5.4	Preferred Stock
Union Pacific	Common	15		
Toledo, St. Louis & Kansas City	Preferred	20	75	Preferred Stock
	Common	12	25	"
Wheeling & Lake Erie	Preferred	12	12	2d Preferred
	Common	9	9	"

Average assessment on preferred stocks.... 9 per cent.
" " " common stocks..... 12½ " "
" " " stocks............. 11 " "
Assessment on bonds unusual in reorganizations of Classes I and II.

Meager though these statistical tables may appear, they afford excellent material for exhibiting historical contrasts and the direction of the current in financial opinion concerning reorganization assessment. In the first place, it is unquestionably clear that the tendency has been toward increasing the amount of assessments. Of the eight representative reorganizations prior to the panic of 1893, the average assessment was only 6 1/3 per cent—and the assessments levied on the common stocks were conspicuously higher than on the preferred stocks and junior bond-holders. A distinct effort was made to apportion the burden in accordance with the priority of the risk. This is readily seen from an inspection of the assessments and the allotment of securities that went with the plan of the reorganization of the East Tennessee, Virginia and Georgia. And in all the reorganizations of the nineties, the average assessment was 11 per cent, and there was less difference

must yield all the new money required by the reorganization. Yet great care must be taken that the assessment is not so large as to frighten the stockholder into relinquishing his interest. To prevent this, the presumptive value of the new securities must be at least a little greater than the market value of the old stocks, together with the assessment, else the stockholders will voluntarily allow their interest to die. Unless the equity remaining to the junior security holder is considerable, the assessment should be just large enough to induce its payment.[43] If the equity properly belonging to the stockholders is large (the embarrassment being readily attributed to specific and easily remedied causes—reorganizations of Class II, as heretofore defined), a very heavy assessment may be levied on the stockholders, as in the reorganization plans of the Missouri Pacific and Rock Island railroads in which the stockholders were asked to contribute $50 and $40 a share respectively. But great care must be exercised that the assessment is not too large, else litigation will result;[44] or, at best, the stockholders will drop out.

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between the assessments on the different classes of stocks. Finally, among the important reorganizations since 1910 (table given on page 113), the average assessment was 34 per cent; in fact, in two large and important reorganizations the assessment was 50 per cent. The tendency, too, is to apportion the assessment more evenly among the various junior security holders.

There seems to be little change in regard to the kind of security given in return for assessments. Except in rare, but rather conspicuous, instances, the new corporation gives the full par value of the assessment in a contingent charge security having first claim after the fixed charge bonds.

[43] An excellent example is offered by the Wabash reorganization plan of April, 1915. Quotations are taken as average for a period of several weeks surrounding the announcement of the plan.

Stock	Market Value of Old Shares	Money Assessment	"Curb" Quotation for the Allotments of First Preferred and Common Stocks Received for the Assessment ($48 for 1st pfd. and $14 for the common)
Preferred	1.37	$30	$31.00
Common	.75	30	30.30

[44] In the reorganization of the Houston and Texas Central (1888), the stock was assessed over 70 per cent—the highest assessment of which the writer has learned; but serious and long-protracted litigation resulted. The plan was first announced covering exchanges for all the bonds. It was accepted by all the bondholders, who, considering that the new bonds were guaranteed by the Southern Pacific Company, were actually benefited by the reorganization. The first announcement contained no stipulation concerning the stock assessment. Some three months

The possibility of a dispute with dissenting stockholders may sometimes be avoided—especially in the case of less serious failures, where large amounts of new money are not essential to a successful reorganization—by giving the common stockholder the option of receiving a small amount of new common stock without the payment of an assessment, or of paying an assessment and getting more liberal amounts of new securities.[45] The apportionment of the assessment

later it was announced to be 40 per cent and still later 73 per cent. Protracted litigation resulted, in the courts of Texas and New York. Ultimately, a compromise was effected with the dissenting stockholders.

[45] Strange to note, this alternative is confined to the two extremes—very mild, usually voluntary, readjustment reorganizations (Class II) and very drastic reorganizations in which all the junior security holders are eliminated (Class I and especially Class III). But there are specific reasons to account for this anomaly.

In the case of the less serious reorganizations, merely readjustments, no foreclosure sale of the property is contemplated. The stockholders cannot, therefore, be forced into paying the assessment. All that can be done is to cajole them into paying it by offering a more liberal amount of new securities than if they refuse. The following examples illustrate this:

Railroad	Old Security Assessed	Amount of Assessment	New Securities
Minneapolis & St. Louis..	Common	$20	$78 in Common Stock
	"	None	22 " " "
	Preferred	$20	80 " " "
	"	None	70 " " "
Western Maryland	Common	30%	45% in valuable coal company stocks
			30 " 1st Preferred
			100 " Common
	Common	None	100 " Common
	Preferred	30%	45 " valuable coal company stocks
			30 " 1st Preferred
			100 " 2d "
	Preferred	None	100 " 2d Preferred only

At the other extreme, the very drastic reorganizations are usually consummated through foreclosure by the underlying or first lien senior bondholders. To make the reorganization effective, and to reduce the payments to the non-assenting bondholders, most, if not all the bonds must be brought into the reorganization plan. This can be done best by offering an alternative consisting of a liberal participation to those electing to pay an assessment, and a smaller allotment of new securities to those who do not.

The following examples illustrate this. They are all Class III reorganizations. The principles governing the assessments on this class will be discussed presently. All securities, junior to the first mortgage bonds were wiped out in every case.

Railroad	Assessment (per cent)	New Securities Given (per cent) 1st Lien Security	2d Lien Security	Common Stock
Gulf, Florida & Alabama.....	25%	50%	25%	25%
	None	10	10	10
New Orleans, Texas & Mexico	20%	20	50	50
	None	..	40	25
Western Pacific	36%	40	55	45
	None	..	12½	50

between the holders of the common and preferred stocks depends on expediency entirely.[46] Presumably the preferred stockholder is in a stronger position than the common stockholder, but experience has shown that he will be compelled now[47] to bear quite as much of the burden as the common stockholders.[48] Sometimes, although not very often, the assessment on the preferred stock is greater than on the common,[49] on the assumption that the preferred shareholder, having more at stake, will endure more without throwing away his security. In no recent case was the assessment on the preferred stock less than on the common. This principle is unfortunately unjust, but, as said before, reorganizations are guided by expediency and not by abstract justice. The bankrupt railroad must have new money.

The discussion of assessments in reorganizations of Class III was purposely omitted from the summaries just given. Each reorganization of this type represents the effort to rehabilitate a small road after a very drastic failure. It is invariably done by the first mortgage bondholders, who alone have any value remaining to their securities. New money must be had and the first mortgage bondholders alone have sufficient interest in the property to be willing to undergo even a slight sacrifice in order to maintain the existence of the railroad. Such cases are illustrated by a few reorganizations of Class III (1910 to 1919).

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[46] Daggett is in agreement with this view when he says with reference to the reorganizations since 1908: "In most instances referred to, common and preferred stock fared alike or so nearly alike that the differences were negligible." Daggett, S., "Recent Railroad Failures and Reorganizations," 32 Q. J. E., 477 (May, 1918).

[47] The contrast between contemporary and past reorganization theory in this particular is brought out in note 42.

[48] This principle is recognized by practical observers of reorganizations, especially by the professional trader who seeks to profit by the wide fluctuations in security values before and after a reorganization. For example, during the autumn of 1914, when the Pere Marquette was in the hands of receivers, a shrewd trader in Boston offered to give 100 shares of the preferred stock in exchange for 100 shares of common and a bonus of $100 in money. He believed that in any reorganization the common would fare as well as the preferred stock, and he would have $100 to his advantage. Unfortunately, for our sense of abstract justice, he was right.

[49] The Toledo, St. Louis and Kansas City reorganization required $20 a share from the preferred stockholders and $12 a share from the common.

RECENT REORGANIZATIONS OF SMALL ROADS (CLASS III)

Railroad	Old Security Assessed	Amount of Assessment (per cent)	Amount of New Security Given for Assessment (per cent)	Kind of New Security Given for Assessment
Cincinnati, Indianapolis & Western..........	1st Mortgage Bonds	30%	30%	1st Mortgage Bonds
Detroit, Toledo & Ironton................	Receivers' certificates	25	41 2/3	Income Bonds
	General Lien Bonds	35	58 1/3	"
	Consolidated Bonds	10	16 2/3	"
Gulf, Florida & Alabama	1st Mortgage Bonds	25	25	Receivers' certificates
Oklahoma Central.....	1st Mortgage Bonds	40	40	1st Mortgage Bonds
New Orleans, Texas & Mexico.............	1st Mortgage Bonds	10	20	1st Mortgage Bonds
Wabash, Pittsburgh Terminal...........	1st Mortgage Bonds	30	30	Preferred Stock
Western Pacific.......	1st Mortgage Bonds	36	40	1st Mortgage Bonds

The radical failure of these little roads is apparent from this table, without further explanation. So serious, indeed, was the failure in one case, that the holders of receivers' certificates were actually assessed.[50] In other cases all the arts of financial persuasion[51] were used to stimulate the interest of the recalcitrant bondholders. They preferred, in many instances, to lose their original investment rather than to meet

[50] Besides the unfortunate Detroit, Toledo and Ironton case, a few other cases exist in which the holders of receivers' certificates were required to undergo a sacrifice. In the reorganization of the Atlanta, Birmingham and Atlantic Railroad in 1914, the holders of $4,476,000 receivers' certificates were required to accept a junior lien fifteen-year income bond. It is interesting to note that in both the Detroit, Toledo and Ironton, and the Atlanta, Birmingham and Atlantic cases the holders of equipment obligations were paid off at par—in the latter case at the time of reorganization, and in the former case through the liquidation of the equipment. Equipment obligations are invariably paid, or left undisturbed at the time of reorganization. For discussion of treatment of equipment obligations, see Volume I, Chapter V, particularly pages 109-111.

[51] One unusual and ingenious instance of personal advantage dangled in the face of the bondholders in order to induce them to pay an assessment is afforded by the reorganization of a little road called the Nevada Central in 1888. In the reorganization there were issued no fixed charge bonds, but only First Mortgage 5 per cent Non-Cumulative Income Bonds—due in fifty years. If, however, any bondholder would pay an initial assessment of 12 per cent on the par value of the bonds, a corporation known as the Nevada Company of New Jersey agreed to guarantee the payment of the semiannual interest during the last forty years of the life of the bond.

a heavy assessment and thereby acquire securities of doubtful value in an enterprise which had shown itself to be a failure.[52]

The query may arise as to whether or not it is expedient for the small stockholder, whose shares are quoted at less than $10 to pay an assessment of several times their market value in order to retain an interest in the new corporation. Both Mead and Daggett in their studies of railroad reorganizations have answered the question in the affirmative for the reorganizations of the middle nineties. "The stockholders of the bankrupt roads make no mistake when they rely upon the future to reimburse them for their sacrifices in the present." [53] Daggett has prepared careful statistics showing that for eight reorganizations of the middle nineties, "the amount of the assessment exceeded the sum for which the common shareholders could have sold their stock one month after the publication of the plan. In other words, the assessments wiped out

[52] A good illustration of this is the reorganization of the Wabash Pittsburgh Terminal Railway. This little road was built as the Pittsburgh link in a prospective Gould transcontinental system of railroads. The property of the company represented an actual investment of $46,000,000, of which over $28,000,000 represented the cost of the terminal in Pittsburgh, and a short section of 60 miles of road forming a junction with the Wheeling and Lake Erie Railroad, and some equipment. The remainder represented the cost of investments in coal properties, a belt line, and the controlling interest in the stock of the Wheeling and Lake Erie Railroad. To finance these expenditures, reputable New York banking firms sold $30,000,000 of the First Mortgage 4 per cent Bonds at approximately 91½. They were acquired by investors throughout the East; in fact, trust funds such as those of educational institutions were placed in them. Some $20,000,000 Second Mortgage Bonds were also sold although they were of an admittedly speculative character. In 1907, with the collapse of the Gould aspirations for a transcontinental railroad system, the Wabash Pittsburgh Terminal Railway passed into the hands of receivers. For upwards of eight years it was operated in an extremely inefficient manner by receivers. The gross and net earnings fell off each succeeding year; the First Mortgage Bonds declined to a value of $1—$10 a $1,000 bond; and the Second Mortgage Bonds became practically worthless—$1.25 for a $1,000 bond. Finally, in 1915, a plan of reorganization was announced involving the assessment of $300 on the First Mortgage Bonds, the holders to receive only non-cumulative preferred stock of a new company in exchange for their assessment. The Second Mortgage Bonds were entirely eliminated as well as the stock. One firm of Wall Street brokers wrote to their customers: "If our surmise proves to be true, it will not pay the bondholders to throw good money after bad. Better let the property go on the auction block for what it will bring as junk and real estate. If this is done, it may happen that the bondholders will get more than two cents on the dollar." Schmidt and Gallatin, Weekly Review (July 2, 1915). A very large proportion of the bondholders refused to pay the assessment, preferring to see the extinction of their original investment. When this plan was announced, an editorial writer of *The New York Times Annalist* remarked: "The experience of these particular bondholders goes to show how very little indeed there is in a name." 6 Annalist, 3 (July 5, 1915).

[53] Meade, "The Reorganization of Railroads," 17 An. Am. Ac. Pol. Soc. Sci., 220 (1901).

the whole value remaining to common stockholders and exacted an additional contribution as the price of participation in any future prosperity. It is needless to add that quotations today are many times the amount of the assessments. The increase in value has occurred alike for common and preferred stock, even in times of severe depression. On the whole, it has abundantly justified the payments which stockholders were asked to make." [54] This was written in 1908, before the long period of the steady decline of railway credit that ended in the assumption of federal control January 1, 1918. In the period from 1908 to 1918 the truth of this quotation has certainly lost much of its force, and there are many instances of railway reorganizations before 1900 in which those who paid their assessments lost the interest and in many cases the principal of their contribution.

At all events historical generalization is impossible. Both Daggett and Mead were reviewing a prosperous period of industrial history. One must recognize that the decade following the depression of 1893-1897 was one of remarkable expansion, in which the railroads of the country had their full share, so that all these reorganizations were profitable to the security holders during the succeeding decade. Had, however, the reorganizations occurred just before a period of depression rather than a period of marked economic prosperity, exactly the opposite result would have occurred. All things considered, it is probably distinctly unwise, from the selfish point of view, for the shareholder in a bankrupt railroad to pay an assessment of more than $5 or $10.[55] The chances are

[54] Daggett, S., Railroad Reorganization, 354 (1908).

[55] That this view is shared by shrewd stock market observers is indicated by the profusion of unasked advice that stock exchange houses offer at the time of reorganization. For example, at the time of the last Wabash reorganization, involving an assessment of $30 on both classes of stock, a New York stock exchange house in their weekly letter, after describing the main features of the plan, commented significantly: "At the present time the old Wabash common and preferred stocks are selling at higher prices than are warranted by the prices of the new securities. To those holders of the old stocks who contemplate paying their assessment, we suggest that they sell their old securities and buy the new, when issued, thus saving the trouble of subscribing, as well as saving a small amount of money." Schmidt and Gallatin, Weekly Review (May 13, 1915).

very much in favor of the new stock selling for less than the assessment during the period following the reorganization while the road is in an enfeebled condition. If, therefore, a stockholder has confidence in the future prosperity of the company he will probably find it to his advantage, if the assessment is over $10 a share, to surrender his old stock and buy the new stock on the open market soon after the reorganization has been consummated.[56] The realization of this fact has acted as a positive influence in holding down assessments on stocks, even though strict economic justice would require a more liberal contribution from the stockholders.

Whether obtained through the assessments on the old security holders or through the sale of new securities to the public, it is necessary for responsible persons to insure that the new railroad corporation receives the money expected. This is done by the reorganization underwriting syndicate, an important and necessary corollary of practically every reorganization plan.[57] Formerly, the "reorganization trustees" were clothed by stockholders, creditors, and the courts, with ample power to superintend the reorganization and secure for the corporation sufficient money. But as one of the two ultimate purposes of every reorganization is to obtain liquid capital for the new corporation, no reorganization can be carried through, no matter how just, unless sources of new money or new credit are certain. Even though an assessment is imposed on the old stockholders, there is no necessity that they pay the amount; in fact, it is sometimes quite uncertain

[56] It might be contended that such a conscienceless view justified the tactics of the curb speculator. But it must be noted that any stockholder who pays an assessment on railroad stock representing no tangible equity is speculating in the most arrant fashion. His act may be looked upon as socially beneficial because it makes possible the rehabilitation of the railroad from which the public will derive benefit. Nevertheless his investment of new money is based on presumptions of future prosperity, unsupported by past events and justified only by a kind of patriotic optimism.

[57] For detailed discussion of underwriting syndicates in general, see Volume II, Chapter VII.

whether or not any large proportion of the stockholders of a road whose shares are selling for less than $10 a share, will pay an amount greater than the market value of their shares. Although the acceptance of a reorganization plan by a committee of large stockholders may give an assurance that a goodly proportion of the assessments will be paid, the attitude of the rank and file of the stockholders will remain unknown until the plan of reorganization is actually put into execution. Meanwhile, the corporation must be assured that in any event the new money will be available. And, further, the willingness of the members of the syndicate—usually represented by prominent bankers—to furnish money to the new corporation, gives a sentimental support to the justice of the reorganization much greater than the exhortations of the reorganization committee.[58] It is this moral support of the reorganization, often quite as vital as the financial support, that justifies the expense of the syndicate and the general importance assigned to it.[59] And in the matter of financial support, a syndicate may guarantee the payment of the assessments by the security holders, and it may purchase outright an issue of new securities to be sold to public investors in the open investment market.[60] So important, indeed, are these underwriting syndicates that almost without a single exception, every railroad reorganization of even medium importance,

[58] It was the success of the late J. P. Morgan in formulating reorganization plans which gradually gave him such a position, during the railway readjustments of the nineties, that his name in connection with any reorganization carried more weight than that of any other banker. As a result, almost all the important railroad reorganization syndicates, with the exception of the Atchison and the Union Pacific, were managed or dominated by the banking house under his control.

[59] Frequently, also, the support of the credit of the new company in the stock exchanges and among the "curb" brokers and "specialty" houses is a matter of great importance. It takes tangible form in the efforts of the underwriters to support the market for the reorganized company's new securities. When a security has any value, trading in it is inevitable. Once the bonds of the new company have been issued, a market will be formed for them, somehow, by those who are forced by circumstances to realize on them before the road has begun to reflect the results of its rehabilitation. The syndicate cannot let the bonds go begging on the market among the curb brokers. Such a course would do lasting injury to the credit of the road and themselves. They must be ready to "hold the basket."

[60] The various purposes of an underwriting syndicate are well stated in the reorganization plan of the Baltimore and Ohio Railroad. See note 67.

consummated since 1890, has been supported by an underwriting syndicate, or else some form of a syndicate which assumes at least some of the functions of an underwriting syndicate.

A syndicate of some sort guarantees the payment of the assessments levied on security holders in practically every reorganization[61] and unless the terms offered the stockholders are very onerous, bankers can always be found to underwrite these assessments for a reasonable commission. The syndicate agreement takes the form of an obligation on the part of the incorporators or others responsible for the new railroad to pay the syndicate either a net commission on the entire aggregate assessment or else a round sum, in the form of a fee. In consideration of this commission or fee, the syndicate contracts to assume the place of any assessed security holder who refuses to pay his assessment. This implies that the syndicate will pay the assessment of the defaulting security holder, and take over the securities of the new corporation allotted to him. As a result of the foreclosure sale, the rights and interest of the defaulting security holder in the new corporation are extinguished.

The ease with which a reorganization committee may secure the underwriting of its plan, and the amount of commission or fees demanded from the new corporation will depend on the amount of risk involved.[62] But, unlike other underwriting

[61] Of course there are exceptions. The securities given in the Pere Marquette reorganization, in return for assessments, were thought to be so valuable that the reorganization managers believed that they could sell the securities of a defaulting bond- or stockholder for the amount of the assessment. Hence they did not feel justified in paying a syndicate a commission for underwriting the assessments. But they did pay a syndicate a "commission" for purchasing some of the bonds.

[62] It is important to observe that it is often necessary to offer the underwriting or purchasing syndicate almost as liberal terms on which to purchase the new securities, as are offered the holders of the old stocks or bonds. This is conspicuously true of reorganizations of the small roads of the third class. In the reorganization of the Western Pacific the old second mortgage bonds and the common stock were eliminated, so the entire brunt of the reorganization fell on the shoulders of the old first mortgage bondholders. They were required to buy new first mortgage bonds at 90 per cent of their par value. The underwriting—called purchasing syndicate—also bought the bonds at 90 per cent. But the old bondholders received approximately 153 per cent of preferred and 264 per cent of common stock as bonus; whereas the syndicate received only 55 per cent in preferred and 14 per cent

syndicates where the payment of money is insured, the syndicate managers can obtain a fairly accurate idea of the extent of the stockholders' probable payments. If they feel that in any plan suggested to them a very large proportion of the old security holders will fail to meet the assessments, the syndicate managers will insist that more liberal terms be offered. If the failure is severe, the old stocks commanding only a nominal market value, and if considerable assessments have to be levied on the old security holders, it may happen that no bankers can be found who will consent to arrange an underwriting syndicate. In such cases, junior bondholders are forced into assuming the status of an underwriting syndicate in that their participation in the reorganization is made conditional upon their willingness to guarantee the stockholders' assessments. Under these circumstances, the junior bondholders have divided among them the unpaid stock assessments and they take over, in corresponding amounts, the new securities to which the defaulting stockholders would have been entitled.[63]

The other important service of an underwriting syndicate at the time of reorganization is the direct purchase of a considerable block of securities of the new corporation. Ordinarily, these securities occupy the status of a general mortgage bond, senior to all the new securities issued at the time of reorganization, but junior to the first, prior lien, and divisional bonds left undisturbed by the reorganization.[64] In fact it may

in common as bonus. This would appear to be liberal treatment to the old bondholders, but a little investigation would show that it was not. Both stocks had a narrow market and little value. (See also notes 64 and 71.)

[63] Such a case is excellently illustrated by the Wabash reorganization of 1915. There were outstanding a little over $40,000,000 junior bonds known as "first and refunding fours." These were to be refunded into second preferred stock at a ratio of 120 per cent. But at the same time, these bondholders were required to assume the payment of the assessments for the delinquent common or preferred stockholders. If all the stockholders paid their assessments, the bondholders would not be assessed; but if none of the stockholders paid, participation by the bondholders involved a maximum liability of $682.76 for each $1,000 bond. These bonds were then selling at $200 in the open market.

[64] Such statements are, assuredly, subject to many exceptions. Sometimes the underwriting syndicate will buy, for money, even the common stock of the new railroad. For illustration, in the very drastic reorganization of the Atlanta, Birming-

even be said that there has been no large and comprehensive railroad reorganization during the last decade which has not involved the purchase of new securities by a syndicate of bankers as well as the guarantee of the payment of the stockholders' assessments.[65] These purchases are ordinarily made by the same syndicate that guarantees the payment of the stockholders' assessments,[66] the two transactions being regarded as part of one agreement.[67] By this arrangement some new money is obtained from independent outside investors.

The compensation of the syndicate and its managers may consist of at least three different emoluments. It will be able to buy the new first or general mortgage bonds for less than the true market value, usually a discount of about 5 per cent. It will receive in addition a reasonable rate of interest and a commission on the actual money advanced during the reor-

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ham and Atlantic in 1916 (plan dated December 15, 1915), the entire common stock was wiped out, and no attempt was made to levy any assessments on any securities. New money was obtained by the sale to a syndicate of the common stock of the new corporation at $12 a share, subject to a commission of 6 per cent in cash. This stock was then offered to the old first mortgage bondholders at that price. In case a bondholder refused to "purchase" the stock, his interest also was extinguished.

[65] The combination of the two functions was very common in the middle nineties, but not quite to the extent that it is now. Of fourteen typical reorganizations studied by Daggett "four provided cash by assessment, three by the issue of securities and five by a combination of both methods." Daggett, S., Railroad Reorganization, 351 (1908).

[66] Cases are by no means uncommon in which a banker or syndicate guarantees the stockholders' assessments and an entirely different one buys a block of new first or general mortgage bonds. Such cases, however, inevitably lead to one banker or syndicate taking the lead, and analysis of the case will usually develop the fact that one of the bankers or syndicates is acting under the direction of the other.

[67] The Baltimore and Ohio Railroad reorganization of 1899 had a composite agreement of this character illustrative of the somewhat elaborate arrangements entered into between the general reorganization committee, acting for the new corporation, and the syndicate of bankers.
The syndicate agreed:

1. To guarantee subscription to $6,975,000 new preferred stock and $30,250,000 new common stock, to be offered to the old first preferred, second preferred and common stockholders.
2. To purchase $9,000,000 Prior Lien 3½'s, due 1925; $12,450,000 First (general) Mortgage 4's, due 1948; $16,450,000 4 per cent preferred stock.
3. "To protect the new company in the ownership and possession" of the property covered by its mortgages, by acquiring the old bonds, at par, from those who would not care to refund them into new bonds. The syndicate agreed to exchange such acquired old bonds for the corresponding amounts of new bonds specified in the plan.
4. To purchase $3,800,000 par value of Western Union Telegraph Company stock at $90 a share. See 66 Chron. 1,235 (1898); also Daggett, S., Railroad Reorganization, 24 and 346 (1908). Plan of reorganization reproduced in Gerstenberg, C. W., Materials of Corporation Finance, 974 (1915).

ganization.[68] It will also receive a considerable bonus in the form of new preferred[69] or common stock,[70] or both. In addition, the rights of the non-assenting stockholders, which revert to the syndicate, may be looked upon as a fourth kind of compensation.[71] In general, the net amount of the special discount on the bonds and the commission on the money advanced may be looked upon as approximately equal to the direct and indirect expenses incurred by the syndicate. A profit can arise only through the development of a substantial value for the stocks received as a bonus. This can occur only if the reorganized company is a success. Obviously, therefore, the members of the underwriting syndicate must assume an active interest and directly co-operate in the future welfare of the road. This interest must, for selfish reasons alone, continue long after the reorganization plan has been

[68] Sometimes—and the practice is growing quite common—the underwriting syndicate arranges with another syndicate of bankers to advance the necessary money. In the St. Louis and San Francisco reorganization of 1916, the ordinary underwriting syndicate, called in this case the Purchase Syndicate because it purchased outright a large block of prior lien bonds, made arrangements with the Loan Syndicate to carry its bonds. The compensation of the former was 4 per cent of the par value of the bonds, and of the latter approximately 2¾ per cent, both commissions being paid out of the assessments on the stockholders. Abstract of the announcement of the purchase syndicate given in Lyon, W. H., Corporation Finance, 267 (1916).

In the Pere Marquette reorganization of 1917 the purchase syndicate received a commission of 5 per cent on its entire obligation, out of which it compensated the Guaranty Trust Company of New York, which formed a loan syndicate to carry the entire obligation of the purchase syndicate on a 20 per cent margin. The use of two syndicates, one to carry the risk and the other to advance the capital, seems to be growing in frequency.

[69] The syndicate which stood back of the Union Pacific reorganization received for its services $5,000,000 in preferred stock (valued at about 60 per cent) and the managing bankers $1,000,000. Daggett, S., Railroad Reorganization, 253 (1908). Such allotments of preferred stock are rare. Distinctly, the commonest form of bonus is a liberal issue of common stock alone without any preferred stock or bonds.

[70] J. P. Morgan's banking house received $750,000 in common stock of the new Southern Railroad for the most difficult of Mr. Morgan's reorganizations. The stock had, at the time, little value.

The amount of commission exacted by bankers for underwriting a reorganization assessment will not be always consonant with the risk involved. If the bankers propose to "manage" the property after the reorganization their charges are apt to be very modest. Thus the bankers who underwrote the final, very drastic reorganization plan of the unfortunate Atlanta, Birmingham and Atlantic of December 15, 1915, demanded less than other bankers had asked for underwriting the previous far less drastic reorganization plan of 1914.

[71] In rare instances, the terms offered to purchase outright new securities are less favorable than those offered the old security holders directly. Thus, in the small, but notably unfortunate, Gulf, Florida and Alabama case, the old bondholders were allowed to purchase, for $250 in money, $500 in prior lien bonds and $250 in second lien and common stock; whereas the syndicate members were given, for the same money price, $400 in the prior lien bonds and $150 in each of the junior securities.

consummated. Taking into account the risks both of money and business reputation which a reorganization syndicate assumes, the compensations given of late years are not exorbitant. They are, comparatively speaking, less than what affiliated bankers demand for the sale of the securities of solvent corporations, when the chance of loss is negligible; they are less, comparatively, than what receivers are accustomed to demand for purely nominal responsibilities involving no permanent risks.[72]

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[72] For other discussions of the reorganization syndicate see Joline, A. H., Reorganizations of Corporations, 56; Daggett, S., Railroad Reorganization, 345 (1908); Mead, E. S., "The Reorganization of Railroads," 17 An. Am. Ac. Pol. Soc. Sci., 205 (1901).

CHAPTER VI

THE REDUCTION IN FIXED CHARGES IN CONTEMPORARY RAILROAD REORGANIZATIONS

Reorganization plans all modifications of the first type, 129; Classes of securities to be dealt with, 130; Treatment of underlying bonds, 131; Treatment of first general mortgage bonds, 140; Treatment of junior bonds, 149; Reorganization of Class II, 151; Reorganization of Class III, 153; Cancellation of burdensome leases, 155; Voluntary reorganization, 159; Effect on total capitalization, 160.

The means for obtaining new money provided in the plan of reorganization, solves only a part of the financial difficulties of the railway. Although some of the less serious railroad failures of Class II (described at the close of Chapter IV) might be overcome by the addition of new capital, the vast majority of railroad failures, including all of Classes I and III, require in addition that the previous load of fixed charges be lightened. A reduction in fixed charges represents that necessary part of every railroad reorganization which goes beyond the amelioration of the temporary distress; it insures continued solvency long after the road has passed through the period of its rehabilitation. This reduction is accomplished most easily by reducing either the interest or the principal, or both, of the road's bonded debt. As with the problem of obtaining new money, the problem of reducing fixed charges is best presented in the comprehensive reorganizations of Class I, and the principles observed to apply to this class may then be applied, in modified form, to the more superficial reorganizations of Class II, and to the drastic reorganizations of small roads of Class III.

At the time of the serious failure of a great railroad system with an intricate financial structure, it is found that there exist at least three classes of bonds or fixed charge securities, one or more classes of contingent charge securities, and the common stock. The three classes of bonds are of three different levels. The first, both in point of time and priority of security, includes the old underlying main line and divisional bond issues created during the period of construction and still secured by first closed mortgages on most, if not all, of the important lines of the railway. The second level consists of an issue of general first mortgage bonds, and possibly issues of second and third mortgage bonds. These bonds embrace the entire railway system. They represent liens subsequent to the bond issues of the first level, when such exist, and a first lien on those parts of the system not covered by underlying liens. These issues were created after the railway system had taken form—during the period of development, in contradistinction to the previous period of construction. The third level represents the numerous junior issues of general, consolidated, or refunding mortgage bonds, debentures and short-term secured and unsecured notes, issued at subsequent times, usually at a considerable discount, or at a high rate of interest. Owing to the differences in lien, these three kinds of bonds are considered separately in effecting a reduction in fixed charges.[1]

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[1] Here, as elsewhere in this treatment of the subject, the point of view is that of the corporation. In the end, and in the widest sense, the point of view of the officers of the corporation and that of the owners of its securities is the same. But at the time of reorganization there is, as indicated in the treatment of the procedure of reorganization, the inevitable conflict of sets of interests. The most conspicuous conflict is that of the corporation represented by its old stockholders and the bondholders who have some value in the property, but whose value is likely to be jeopardized by concessions made to other security holders.

It was pointed out in the first part of the chapter on reorganization procedure that various considerations affected the adjustment of the interests involved in a reorganization, and perhaps it might be pertinent at this point to indicate the considerations that affect the interests of the bondholders as such, without reference to the other security holders or the permanent welfare of the corporation.

There are five fundamental considerations which determine the treatment of any given issue of bonds and it is of value perhaps, to summarize these at a single point of our narrative. The first two are concerned with the nature of the corporation without reference to the bond issues involved in the reorganization. Two other sets of conditions are concerned with the economic and strategic position

The first step in the problem of reduction of the interest charges on the bonded debt is the determination of the posi-

of the specific issue of bonds, in relation to the other obligations and liabilities dealt with in the reorganization. The fifth set of conditions are the legal privileges, restrictions, and limitations with which any bond issue is clothed.

The first set of conditions is concerned with the public attitude toward the necessity and social importance of the business conducted by the corporation of which the bonds are an obligation. At the one end of the series is a privately owned water company, the business of which is so essential to the life of the community which it serves that public officials exercise a strict supervision over the conduct of its business. Of slightly less public importance, but nevertheless of inestimable economic importance, are the railways. At the other end of the series are the small locally owned manufacturing businesses engaged in the production of unimportant luxuries, of which the supply is always ample. The attitude of the public, as crystallized in judicial precedents and statutory law, toward the public character of a business, has much to do with the treatment of the corporation's bonds at the time of reorganization. If the business of a bankrupt corporation is invested with a public character, the courts will permit a great variety of past and present debts to be superimposed above the liens of all the bonds—even the underlying first mortgage bonds—provided such a course is necessary to keep the public service enterprise in actual operation. On the other hand, a bankrupt business not invested with a public character will be liquidated by the courts for the benefit of the creditors, and a general creditor can obtain, only in extreme provocation, a claim on the corporate assets sufficiently strong to emasculate the security of the mortgage bondholders.

The second set of conditions is concerned with the specific character of the business conducted by the bankrupt corporation of which the bonds are a liability. By that, one means the kind of commodity which it furnishes, the market it supplies, the liquid or fixed character of its assets, the rapidity with which its capital is turned over, and its natural capacity for borrowing capital. There is one type of business requiring a large amount of fixed capital, of which a power dam is an illustration, which has no current quick assets that can be sold for the benefit of creditors. It requires little or no working capital and, therefore, once it is in operation, it requires no loans from the banks. It supplies a relatively stable market; the services it sells cannot be "trade-marked" and little business skill is required for its administration. At the other extreme is the type of business which requires little fixed capital—like a tannery—where the current assets constitute about all there is to the value of the corporation's property. The capital is "turned over" rapidly; the volume of purchases and sales fluctuates rapidly, so that large amounts of bank credit must be available at certain times. It produces a commodity for a highly competitive market, and great skill is required for the administration of the business. In the reorganization of the former type of business, general as well as underlying bonds may be left undisturbed, because the reorganized corporation will have an assured and relatively constant earning power, and no need would arise for securing bank loans to carry, temporarily, an unusually large volume of business. In the reorganization of the second type, the old bonds must be scaled down to the lowest possible point, and in reorganization plans of markedly good technique all bonds of the bankrupt corporation are converted into stock. The plan must safeguard, above all else, the general borrowing credit of the reorganized corporation, and preserve the organization, the good-will, and the trade standing of the business. A bond, even a mortgage bond, of such a business is an empty symbol, unless these intangible elements are maintained.

The third set of conditions pertains to the earning capacity of the particular property which secures one bond issue—in contrast to another bond issue of the same bankrupt corporation. In the reorganization of a large railway system, a large local utility, an industrial "trust" of hybrid origin, there are usually several separate issues of bonds. One issue is secured by a mortgage on one piece of property, another issue by a mortgage on an entirely different piece of property. And the two pieces of property have probably contributed differently to the earning capacity of the bankrupt corporation. Obviously the bonds secured by the more lucrative property must be treated more liberally than those secured by property having a less inherent earning capacity. Obviously no bondholders can be asked, under any circumstances, to accept new securities in a reorganized company which will yield less income than the separate earning capacity of the property securing the bonds; and, equally self-evident, bondholders whose only security is property having little or no independent earning capacity may be justly asked to endure any sacrifice in income short of the complete extinction of their investment.

The fourth set of conditions has to do, again, with the property securing an issue of bonds—the strategic significance (rather than the explicit earning capacity)

tion of the old underlying or divisional mortgages. Invariably, unless the railway system has been reorganized before, and even then unless the previous reorganization has penetrated to the marrow, there will be found a host of underlying bonds, on branch lines and subsidiary roads, that have been allowed to continue in force because there seemed nothing else to do. These carry, ordinarily, high rates of interest; they mature at various dates and are secured by dissociated and often unrelated sections of line.

In a few of the earlier railroad reorganizations a temporary reduction in the charges on these underlying bonds was accomplished by requiring the holders either to refund or else surrender the coupons covering a definite period of years.[2] This effected merely a temporary relief and was based on the presumption that earnings would improve in a short time.

of the property. For it is true that in any complex financial structure the property securing one bond issue is more essential to the operation of the business as a whole than the property securing another. Obviously the former issue must be treated with conspicuously greater liberality than the latter. This distinction is of great importance in adjusting the relative interests of different small, separately secured bond issues in every complex reorganization, but it is especially important in the reorganizations of large railway systems. For, obviously, the holders of bonds secured by a mortgage on the main trunk stem of a railway system must be treated with the utmost liberality. They must be treated in actual practice with much greater liberality than the holders of bonds secured by a mortgage on a branch line, the traffic on which is important but not absolutely essential to the integrity of the reorganized property.

The fifth set of conditions to be considered is legal. The futility of reliance, on the part of the bondholder, solely upon the legal privileges of his bond issue has been constantly before us in this study of reorganizations. Superficially the legal form of a bond issue may seem to present conditions of great importance in determining its status with reference to other bond issues. In reality, the legal rights and privileges with which the bond issue is protected are not of great importance compared with the other considerations already outlined. The legal consideration which is, perhaps, of the most significance in determining the status of the bond issue is the question of the general machinery adopted in putting the reorganization into effect. If the reorganization follows a foreclosure of one of the bond issues and a judicial sale of the assets of the corporation, severe pressure can be brought on all the junior bondholders. If, on the other hand, no foreclosure sale is ordered by the court, the plan of reorganization must be carried out with the consent of all the bondholders, and every bond issue must be treated, therefore, with great leniency—often irrespective of the equities of the situation.

These matters were outlined in more detail in An. Am. Ac. Pol. Soc. Sci. 23 (March, 1920).

[2] Thus in the Chesapeake and Ohio Railroad reorganization of 1878 the First Mortgage bondholders funded the coupons of the three following years into preferred stock and the Second Mortgage bondholders the coupons of the next six years. A similar plan was followed in the Erie reorganization of the same year. When a railroad found itself in financial difficulties during the period from the panic of 1873 down to that of 1893, the funding of coupons was the first expedient suggested and usually followed. Thus the old East Tennessee, Virginia and Georgia began its career of manipulation and misfortune in 1884 by the funding of coupons. 40 Chron., 29.

It is, however, a method of reducing fixed charges never adopted at the present time, when the guiding principle of every railroad reorganization is to secure permanent strength.

Since the reorganization of the Wabash system in the late eighties, historically the first of the great comprehensive railroad reorganizations of Class I,[3] it has become the established practice to refund most, if not all, of the underlying and divisional issues into a single issue of first mortgage long-time bonds, bearing a low rate of interest and smaller, in principal, than the old underlying and divisional issues.[4] It substitutes a single, large bond issue for a heterogeneous mass of small issues; it simplifies the railroad's financial structure. It probably reduces the burden of fixed charges, and it may even reduce the principal of the outstanding bonded debt. From every point of view, therefore, this substitution is now[5] regarded in the light of an advantage to old bondholders and to the railroad.[6]

The difficulty involved in securing the refunding of these issues lies in adjusting a fair equivalence between the old security and the new, and then in the very great practical

[3] For the outlines of this important reorganization, see Chapter IV, page 77.

[4] In a few rare instances the old issues are continued, with a direct reduction in the interest rate. This is practical only where there are one or two bond issues and a general simplification of the financial structure is not required. Thus in the reorganization of the Colorado Midland in 1897, the interest rate on the underlying bonds was reduced from 6 to 4 per cent.

[5] This has not always been true. Prior to 1887 there were comparatively few comprehensive refunding operations, and these few were invariably carried on under coercion. The editor of *The Commercial and Financial Chronicle* had this to say as late as 1885, commenting on the Denver and Rio Grande plan of reorganization, "It is most important that the idea should get abroad and be established beyond a question that a small first mortgage on a large railroad property will never be disturbed, and that the priority and sanctity of its lien will in no way be interfered with, whatever may happen to the junior securities." 40 Chron., 480 (Apr. 18, 1885).

[6] This is very well expressed in the circular of the Northern Pacific Reorganization Committee of March 16, 1896, advising the holders of the old General Mortgage 6 per cent Bonds of 1921 covering part of the system, to exchange them for 135 per cent of new Prior Lien 4 per cent Bonds of 1997 covering the entire system. "It is manifestly to the benefit of the holders of the General First Mortgage Bonds to secure an investment of longer continuance, and it is also to the benefit of all subsequent securities to diminish this unnecessarily large burden of annual fixed charges. . . . The advantage is obvious of a mortgage resting upon a complete and entire system, including main line and all branches brought into the new company, together with terminals, land grants and equipment, and having over $200,000,000 of bond and share capital behind it, securing a gold bond running for one hundred years, as compared with a bond at all times liable to compulsory retirement and secured by only part of the system." Plan given at length in 62 Chron., 550 (1896).

difficulty of making the holders of these bonds consent to the exchange. No reorganization can succeed which is opposed by all concerned. No reorganization can succeed which is fundamentally unjust. Much care must therefore be exercised in arranging a fair exchange for the holders of the old bonds.

In determining the relative value of these old underlying and divisional bonds, reorganization managers are concerned with the fundamental property values behind the bonds—not with the legal status or legal phraseology of the bonds and their mortgage. The basis of exchange is economic and not legal. In assessing their economic value, two considerations are of primary importance: the essential earning capacity and the strategic position of the property covered by the bonds. In other words: What does the security of the bonds earn? How important to the reorganized road is the property covered by them? The first question can be answered only in terms of past experience, and it is frequently important to segregate individual station freight statistics and passenger receipts according to the lines covered by separate mortgages in order to ascertain the immediate earning capacity of the lines covered by those liens. This is particularly important in the case of branch and subordinate divisional lines, because the quantity and relative significance of the traffic originating on each line can be specifically determined; but it is of no importance in determining the earning power of main lines, owing to the impossibility of allocating the receipts and costs of operation of different types of freight on the main lines. The other consideration, that of strategic importance, can be determined roughly by an inspection of the railway map. The main lines have the greatest strategic importance and must be preserved at all hazards. Those branch lines which run into isolated unproductive territory have least. If the line would be of considerable importance to a competing railway system, the reorganization managers must face the possibility that, in

case the bonds are disturbed, the bondholders may bid in the property and sell it to the competing system. In other words, the strategic importance of the line to the reorganized railway is affected by the answer to the question, What would, or could, the bondholders do if they assumed control of the property? If the line could exist independently, the bondholders must be treated liberally; if the line would be of no value independent of the reorganized company, then the bondholders can be counted upon to accept any reasonable offer made to them.

Generally speaking, there are three classes of the underlying bonds, arranged according to the fundamental earning capacity and strategic importance of the lines by which they are secured. There are first the old underlying first mortgage bonds on the main line. These are of primary importance to the system; in fact, without these lines there is no railway system at all, merely unconnected branches. Not only does traffic arise on these main lines, but over them moves the branch line business. The second class includes the later mortgages on the main line divisions and the liens on important branch lines possessing an assured independent earning capacity and considerable, though not essential, importance to the system as a whole. The third class includes the first and subsequent mortgage bonds on unimportant branch lines. Such lines will have failed to earn their fixed charges, and are, from any point of view, of little value to the system as a whole.

In arranging a proper basis of exchange between the old underlying bonds and the new securities to be given in order to refund them, great care must be exercised that these differences are recognized. In each case the offer of exchange must be sufficiently liberal to guard against the need for large amounts of money to settle with the non-assenting bondholders,[7] yet not so liberal as to defeat the essential end of

[7] In order to bring the property covered by underlying bonds completely

the reorganization by overburdening the new company with fixed charges. Each class and each issue must be evaluated by itself.

In rare cases, especially if there exist one or two small, main line issues, these underlying bonds are paid off in money.[8] If one or two of these small issues bear low interest rates, or mature shortly, they are allowed to remain unaffected by the reörganization—"undisturbed," as the phrase is. This may make the reorganization easier or cheaper to accomplish[9] but it makes the financial structure of the reorganized road more

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under the cover of a new general first mortgage bond issue, when some of the underlying bondholders refuse to come into the reorganization, it is necessary to foreclose the mortgage. The recalcitrant bondholders are then paid off their proportion of the price realized at the foreclosure sale. It is invariably less than par. In the last Pere Marquette reorganization there were ten underlying and divisional issues. All the bonds of two issues were exchanged, the trustees being able to cancel the issues without foreclosure. Less than 3 per cent of all the underlying and divisional bonds were undeposited and had to be paid in money. For rates of settlement in this particular case, see Chapter III, note 67.

[8] Thus in the thoroughly comprehensive reorganization of the Northern Pacific Railroad in 1896 two small main line issues were at first undisturbed and then paid off in money. Together they represented about $2,000,000—$1,834,500 Missouri Division 6's (1879-1919) and $369,000 Pend d'Oreille 6's (1879-1919)—whereas the property involved in the reorganization exceeded $200,000,000.

Ordinarily these small, underlying, high interest-rate bonds are worth well above par; and reorganized managers have, in the past, been accused of allowing a default in interest so as to force the holders to accept the payment of their bonds at par. This particular procedure was very vigorously condemned by the editor of *The Commercial and Financial Chronicle* in 1896, when many of the comprehensive reorganizations of the middle nineties were being discussed. "When," in the words of this financial observer, "these old underlying mortgages bear a high rate of interest and have also a good many years to run to maturity, there is of course an obvious advantage to a company in paying them off and replacing them with obligations bearing a lower rate of interest. In such a case it is difficult to resist the conclusion that the default has been made with design or is being purposely continued in order to force the holders to consent to the paying off of their bonds or to make concessions which it is not needful or right that they should make." 62 Chron., 525 (March 21, 1896).

[9] Various reasons exist which justify the continuation, undisturbed, of a few of the old issues. Sometimes these issues are so small that it seems inexpedient and too expensive to induce the holders to exchange them. Thus in the comprehensive reorganization of the Erie in 1895 none of the old underlying issues of the original New York and Erie Railroad were disturbed. Many of these bonds were held in England, many were in the treasuries of insurance companies. All of them commanded a high credit as investment securities, so that it would have been very difficult, if not impossible, to have induced their holders to have exchanged these underlying bonds for any of the second-rate securities of the new Erie Railroad, created at the reorganization. Similarly, in the last reorganization of the St. Louis and San Francisco Railroad in 1916, an issue of $9,000,000 underlying First Mortgage Bonds of the original St. Louis and San Francisco Railway, issued in 1881 and due in 1931, was not disturbed. The bonds had not been disturbed in the previous comprehensive reorganization of the St. Louis and San Francisco Railway in 1896.

Sometimes the underlying issues are destined to mature in a few years, and the saving in interest, through refunding them, will not compensate for the trouble and expense involved. In the numerous comprehensive reorganizations of the middle nineties, these underlying bonds were, for the most part, refunded. This is indicated by the statistics of the 57 reorganizations studied by Meany. They involved approximately $1,250,000,000 of bonds of all descriptions. Of these, less than $200,000,000, or 15 per cent only, were undisturbed. Poor's Manual of Railroads, 1900.

complex. Ordinarily, however, even when the issue is of the highest grade of main underlying bonds, the reorganization managers will refund them into a new first general mortgage by offering their holders special inducements.[10] If the new general first mortgage bond issue carries a lower rate of interest than these old underlying issues, as is very probably the case, the bondholder must be offered an increase in principal to equalize or compensate the lower interest rate.[11] Quite often he is offered in addition a bonus of new preferred stock so that, should the reorganized railroad prove successful, he will receive an actual increase in income.[12]

[10] If the securities outstanding upon the main line section are all out of proportion to the earning capacity of the physical property, then there must be a severe cutting down not only of fixed charge bonds but also of the stocks given as a bonus. This is illustrated in the refunding of securities of one of the affiliated Erie companies in the last Erie reorganization. At the time this affiliated line was called the New York, Pennsylvania and Ohio. It had been chartered in 1858 as the Atlantic and Great Western to unite certain small lines in and about Meadville, Pa., and ultimately became a very important main line link in the Erie's New York-Chicago system. It was financed by a Spanish-French nobleman and English capitalists brought into the project by James McHenry, famous in the later history of the Erie Railroad. It was a failure from the beginning, although its history, under the administration of McHenry, Gould, and General McClellan, forms one of the most dramatic recitals in the history of American railroad promotion. It was either leased to the Erie, or in the hands of receivers continuously. In 1894 when it finally became an integral part of the Erie system, its capitalization was at the rate of $395,000 a mile—about all of which had been contributed by foreign capitalists. Its reorganization involved one of the most extreme sacrifices which foreign bondholders of a prominent American railroad have been compelled to undergo. The First Mortgage bondholders received 20 per cent in new First General 4 per cent Mortgage Bonds and 27 per cent in stocks. The Second Mortgage bondholders were given only 20 per cent in common stock—then valued on the market at less than $10 a share. Finally the common shareholders of this unfortunate "main line" division were offered 1 per cent of their principal in this same common stock.

[11] This has been necessary in practically every comprehensive reorganization. The treatment of the underlying bonds in one of the two recent comprehensive reorganizations is seen from the table given presently (page 141). But the practice was common in the great comprehensive reorganizations of the middle nineties, as these three cases indicate:

Name	Percentage of New Bonds	Saving in Interest Rate (per cent)	Net Reduction in Fixed Charges (per cent)
Norfolk and Western Adjustment Mortgage 7's	130%	3%	1.8%
Northern Pacific			
First Mortgage 6's	135	2	.6
Second " "	118½	2	1.3
Third " "	118½	3	2.5

In the case of the Baltimore and Ohio reorganization, the holders of some of the underlying bond issues were offered the principal in low (3½ per cent) First Mortgage Bonds, and a bonus of 12½ per cent in Second Mortgage 4's. The exact result was therefore very difficult to compute.

[12] A good illustration of this principle is the treatment of the underlying 6 per cent First Mortgage bondholders in the old Toledo, St. Louis and Kansas City reorganization. There was due on these bonds 30 per cent of unpaid interest, yet the earnings of the road were ample to meet the current interest on the bonds.

Underlying bonds of the second class, later liens on the main lines and first liens on the important branch lines, can be treated much less tenderly than bonds of the first class. The holders of this second class can be forced to undergo some sacrifice, because they will recognize that even if they can make their properties pay, by operating them independently, it will involve large expense and much trouble. Consequently, they will refund their bonds if the offers of the reorganization committee are at all reasonable. It is possible, therefore, to count on a slight reduction in fixed charges from this class of bondholders.[13]

Clearly, the bondholders would expect that their unpaid interest should be paid, yet so much new money was required to meet the necessary charges that it would have been practically impossible for the stockholders to secure the necessary money. A compromise was necessary. The bondholders were given 100 per cent in new 3½ per cent Prior Lien Bonds and in addition 62½ per cent in new 4 per cent Second Mortgage Bonds, and 30 per cent in new preferred stock. By this arrangement they would receive the same stipulated income, $60 a year, but the principal of their bonded lien was increased and the bondholder had the opportunity of an increased income should the reorganization prove successful.

[13] Under date of October 15, 1915, the various reorganization committees of the Missouri Pacific Railway published an "Analysis of the Security for the Bonds Dealt with under the Missouri Pacific Plan of Readjustment." Although the Missouri Pacific, so far as the main structure of the system is concerned, was not a comprehensive reorganization of Class I, as here defined, still it did seek to simplify and refund the bonded debt on many of the branch lines. And this "analysis" is a somewhat remarkable document in the annals of reorganization history, in that it laid before the public, in unequivocal form, the simple strategic motives which lead reorganization committees to deal with railroad bonds according to the security behind them and not according to the letter of their legal form.

For example, it was proposed to refund a certain collateral trust mortgage bond due in five years into a bond of the same interest rate, due in fifty years. This bond might well be considered as belonging to the second class, referred to above. Its security consisted of unimportant main line sections, and important branches. No sacrifice of either principal or interest was demanded of the owners, ostensibly, yet in being required to refund a 5 per cent bond due in five years into one due in fifty years, when the credit of the road was not on a 5 per cent basis, they were being asked to undergo at least a temporary sacrifice.

"$9,636,000 Missouri Pacific First Collateral Mortgage 5 per cent Bonds due 1920: These bonds, like the Trust 5's of 1917, are secured not by direct mortgage but by pledge of smaller bond issues. There are nineteen of these issues, of various maturities, secured by separate first mortgages on nineteen sections of the system in Kansas, Nebraska, Missouri and Tennessee." [Then follows the list of securities securing the collateral trust issue. This list, with brief comments, is reproduced in Volume I, Chapter III, note 39 (pages 55 and 56).]

"Even portions of the main line indirectly covered might be omitted from the system of the new company and its traffic cared for by other means; or the new company might, by paying part of the pledged bonds of earlier maturities and paying interest on additional pledged bonds of later maturities and the principal when due, acquire about one-half of the mileage covered indirectly by this issue, including all portions of the main line so covered, leaving the Collateral 5's to realize a large deficiency from pledged bonds in default secured on branches not taken over by the new company. There would probably be deductions for expenses of collection of the deficiency, and assessments upon the Collateral 5's would doubtless be necessary for development of the branches not taken over by the new company. Considering these conditions, it is believed that the intrinsic value of the Collateral 5's, as well as the measure of importance and value to the system of the properties comprised in their security, is recognized by the offer of 100 per cent in new First and Refunding 5 per cent Bonds secured by a system mortgage

The third class of underlying bondholders, can be treated very arbitrarily. Their properties have little value. Under no stretch of the imagination could they be made profitable if operated independently. In extreme cases they will not even be admitted into the reorganization. At most they will be given only a small percentage of new fixed charge bonds; and ordinarily they will be offered contingent charge securities such as income bonds, preferred stock, and common stock. Under any circumstances the refunding of this class of bonds will effect a conspicuous saving in the new fixed charges.[14]

These principles can be understood from the detailed study of the refunding operation in one of the recent[15] comprehensive reorganizations, that of the Pere Marquette Railroad in the autumn of 1916.[16] In this reorganization all[17] of the under-

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covering a large mileage with diversified traffic, which is believed to afford a greater measure of safety than the existing collateral." Analysis, page 4.

Or again, the strategic value of an important but not essential bridge is carefully weighed.

"$393,000 Little Rock Junction Railway First Consolidated 6 per cent Bonds due 1916, guaranteed by the Iron Mountain Company. These bonds are secured by mortgage upon an important bridge property near Little Rock, and their co-operation in the plan is of value to the new company. On the other hand, the Iron Mountain Company is not without an alternative route into Little Rock, and the Iron Mountain traffic is believed to be essential to the value of this bridge property. In view of these considerations the plan offers to holders of these bonds 100 per cent in new First and Refunding 5 per cent Bonds." Ibid.

Regarding intention of the reorganization managers to force underlying divisional bondholders to accede to their plan, an editorial writer discussing the Missouri Pacific plan remarked: "The security holders may be assumed to know what it means to be told that although the holder of a mortgage bond may foreclose his mortgage the property will be useless to him, and that although the holder of a collateral trust bond may capture the collateral he will be unable to do anything with it." 6 Annalist 36 (July 12, 1915).

[14] The "analysis" of the Missouri Pacific branch line securities, referred to and quoted in the preceding note, thus disposes of four unimportant branch lines:

"$650,000 Missouri Pacific—Lexington Division 5 per cent First Mortgage Bonds, due 1920. $520,000 Leroy and Caney Valley 5 per cent First Mortgage Bonds, due 1926. $1,024,000 Kansas City Northwestern First Mortgage 5 per cent Bonds, due 1933. $500,000 Boonville, St. Louis and Southern First Mortgage 5 per cent Bonds, due 1951. These four issues of bonds are secured by first mortgages upon branches which it is believed could without material detriment be dropped from the system. It is estimated that for some time past none of these branches has yielded any substantial excess above operating expenses, while some of them have been operated at an actual loss. Their potential values as contributors of traffic to the system or otherwise are believed to be fully recognized by giving them 100 per cent in new convertible 5 per cent preferred stock." Ibid.

[15] A much more intricate case, illustrative of a comprehensive, but not drastic reorganization of the middle nineties, is that of the Baltimore and Ohio Railroad. The plan of reorganization is easily accessible in Gerstenberg, C. W., Materials of Corporation Finance, 966 (1915).

[16] Throughout this discussion the Pere Marquette reorganization of 1916 is used as an illustrative case. It is the most thoroughly typical of any of the recent reorganizations of Class I.

[17] Except for two small issues covering 199 miles of a Canadian subsidiary.

lying and divisional bonds were refunded into a single issue of general first mortgage bonds—part of which bore 5 per cent interest and part 4 per cent. There were in all eleven separate issues of underlying and divisional bonds, aggregating $26,314,000[18] and carrying fixed charges to the amount of $1,275,160, or an average of 4.8 per cent. These eleven issues occupied very different strategic positions, both with respect to the status of their lien and the geographical position of the section of the railway securing them. The earning capacity of the branch lines varied also. With these differences, it is possible to classify these eleven issues into the three classes described in an earlier paragraph.[19] (Tables pages 141 and 142.)

As a result of the process of refunding, the principal of these underlying and divisional issues was reduced by almost $5,000,000 and the fixed interest charge from $1,275,160 to $982,140—a reduction in charges of over 22 per cent.

Leaving now the whole class of underlying bonds, in the refunding of which no great saving in fixed charges can be anticipated, we come to the second level of bonds, that represented by the first mortgage liens covering the entire system. The problem of dealing with these bonds presents no such complexity as that attending the refunding of the underlying and divisional liens. If, as is quite often the case, the interest charges on these bonds were fully earned before and during the receivership, they must be treated with a full consciousness of the strength of their position. As the mortgage covers the entire road, these bondholders would have the power to foreclose their lien on the whole system and put through a reorganization of their own which would exclude both the

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[18] In this paragraph and in the tables pertaining to it, no cognizance is taken of the unpaid coupons. These were, for the most part, refunded into the same kind of security as the principal of the bond. A consideration of them, however, merely introduces complexities.

[19] One interested in relative values should compare the tables on pages 141 and 142 with that given in Chapter III, note 67, in which the court's "Decree, value" of each of the bonds is given.

PLAN OF REFUNDING UNDERLYING AND DIVISIONAL BONDS, PERE MARQUETTE REORGANIZATION OF 1916

Name	Old Underlying and Divisional Bonds					New Securities Used for Refunding			
						First Mortgage			
	Interest Rate	Principal	Fixed Charge	Character of Lien	Class of Underlying Bond	5 per cent		4 per cent	
						Per cent	Amount	Per cent	Amount
Flint & Pere Marquette First Mort.	6%	$4,000,000	$240,000	Main line	1	100%	$4,240,000	......	....
Flint & Pere Marquette First Mort.	4	1,000,000	40,000	Main line	1	100	1,000,000	......	....
Detroit, Grand Rapids & Western First Cons.	4	5,379,000	215,160	Main line	1	......	....	100%	$5,379,000
Chicago & West Mich. First Mort.	5	5,758,000	287,900	Main line	1	100	5,758,000	......	....
Toledo Division First Mort.	5	400,000	20,000	Important branch	1	100	400,000	......	....
Flint & Pere Marquette First Mort.	5	2,850,000	142,500	Main line (2d lien)	2	56.2	1,601,600	50	1,425,000
Indiana Division First Mort.	4	675,000	27,000	Branch	2	......	....	100	675,000
Saginaw, Tuscola & Huron First Mort.	4	1,000,000	40,000	Branch	2	......	....	100	1,000,000
Port Huron Division First Mort.	5	3,325,000	166,250	Branch	3	......	....	......	....
Chicago & North Michigan First Mort.	5	1,667,000	83,350	Unprofitable branch	3	......	....	......	....
Grand Rapids, Belding & Saginaw First Mort.	5	260,000	13,000	Unprofitable branch	3	......	....	......	....
		$26,314,000	$1,275,160				$12,999,600		$8,479,000
									$21,478,600

(Table continued on next page)

PLAN OF REFUNDING UNDERLYING AND DIVISIONAL BONDS, PERE MARQUETTE REORGANIZATION OF 1916—(*Continued*)

Name	New Securities Used for Refunding (*continued*)						
	5 per cent Preferred Stock		Common Stock		Fixed Charge	Increase or Decrease	Contingent Charge
	Per cent	Amount	Per cent	Amount			
Flint & Pere Marquette First Mort.	....	....	....	....	$212,000	−$28,000	....
Flint & Pere Marquette First Mort.	....	....	....	....	50,000	+10,000	....
Detroit, Grand Rapids & Western First Cons.	....	....	....	....	215,160	same	....
Chicago & West Mich. First Mort.	....	....	....	....	287,900	same	....
Toledo Division First Mort.	....	....	....	....	20,000	same	....
Flint & Pere Marquette First Mort.	....	....	....	....	137,080	−5,420	....
Indiana Division, First Mort.	....	....	....	....	27,000	same	....
Saginaw, Tuscola & Huron First Mort.	....	....	....	....	40,000	same	....
Port Huron Division First Mort.	60%	$1,995,000	30%	$997,500	....	−166,250	$99,750
Chicago & North Michigan First Mort.	33⅓	555,700	66⅔	1,111,400	....	−83,350	27,785
Grand Rapids, Belding & Saginaw First Mort.	....	....	100	260,000	....	−13,000	....
		$2,550,700		$2,368,900	$989,140	−$286,020	$127,535

junior bondholders and all the stockholders. They cannot, therefore, be asked to endure much of any sacrifice, although they can be counted on to co-operate in the simplification of the financial structure of the new road by refunding their bonds. Generally, however, the interest on these general first mortgage bonds was only partially earned before and during the receivership. In this case the bonds are refunded into a fixed charge bond and a contingent charge income bond or stock, the proportion depending on the relative strength of the old bonds.[20] In the extreme cases in which the interest on these general first mortgage bonds was not earned during the receivership, they are invariably refunded into a contingent charge security. Usually this is a preferred stock, ranking after the security given for the stockholders' assessments.[21]

The commonest method of dealing with these first general mortgage bonds is to refund them into a mixture of fixed and contingent charge securities, as described in the preceding paragraph,[22] because there is usually grave doubt whether or

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[20] This is well illustrated by the comprehensive reorganization of the St. Louis and San Francisco in 1916. Following the underlying and divisional liens there were $68,500,000 First General Mortgage Bonds bearing 4 per cent interest. These were refunded into 75 per cent Prior Lien 4's—the issue that became the First Mortgage on the entire system and the same issue that was given for assessments and used to refund the underlying liens—and 25 per cent of a First Income 6 per cent Bond, the issue next following the prior lien mortgage. Although the interest on these income bonds was contingent on earnings, the current earnings of the road gave good assurance that it would be paid. This being the case, the holders of the old bonds would receive a slightly greater investment return, 4½ per cent instead of 4 per cent; but 1½ per cent was contingent.

[21] This was exactly the plan pursued in the other recent comprehensive reorganization, that of the Pere Marquette. The reorganization could very well be drastic because, by inordinately large depreciation charges on rolling equipment the receiver had worked out an operating ratio of 106 per cent in 1914! (For further discussion of this interesting case, with figures, see Volume III, Chapter II, note 11. Nevertheless, even if less rigorous charges to depreciation and repairs had been made, the operating ratio would have been about 90 per cent, and the 10 per cent available for interest charges would have been fully absorbed by rentals and the interest on receivers' certificates and underlying and divisional liens. Consequently holders of the First General Mortgage Bonds ($8,382,000 Consolidated 4's of 1951) were required to accept their principal and unpaid coupon interest at par in new second preferred stock—the security ranking directly after a first preferred stock given for the stockholders' assessments.

[22] This was almost invariably the method of treating this level of bonds in the comprehensive reorganizations following the panic of 1893. The actual working out of the procedure, in a rather complicated case, is shown by the final reorganization plan of the Baltimore and Ohio. Details in 66 Chron., 1,235. The Baltimore and Ohio reorganization plan is almost completely reprinted by Gerstenberg, C. W., Materials of Corporation Finance, 966 (1915). An enlightening summary is given in Daggett, S., Railroad Reorganization, 24-27 (1908).

not, had adequate depreciation and maintenance charges been made, the interest on this level of bond would have been rightfully earned. When this method of refunding is used, fairness demands that the volume of contingent charge securities given to offset the reduction in fixed interest shall be such that if the earnings of the reorganized road prove to be so large as to have warranted the payment of the old rate, then the payments in these contingent charge securities will more than make up the balance. That is, if an old 5 per cent first mortgage bond issue is refunded into 4 per cent bonds, par for par (or into bonds bearing the same rate but with reduced principal), then in addition the old bondholders should be given enough preferred stock or income bonds to amount, when the contingent charge is paid, to more than the reduction in fixed income return—in this case 1 per cent. Therefore, in addition to the new 4 per cent bonds, the old bondholders should be given enough preferred stock, so that the income on it, if paid, will amount to at least 2 per cent. This acknowledges that the first mortgage bondholder, by accepting part payment in a contingent charge security, becomes at least partially a partner in the fortunes of the enterprise. As he accepts a share of the burden of low earnings, he should be given a chance to profit through increased earnings.[23]

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[23] This was illustrated in the refunding of the General First Mortgage Bonds in the St. Louis and San Francisco reorganization. See note 20.

Perhaps the best illustration of this principle on a large scale is afforded by the second Atchison reorganization. The first reorganization of 1888 and the second reorganization of 1895 were actually the successive parts of a single comprehensive reorganization, the first part refunding the underlying and divisional issues and the second part accomplishing a permanent reduction in fixed charges and the collection of new money from the junior security holders. At the time of this second reorganization, the net earnings, as corrected by Stephen Little, were less than $6,000,000. The rentals, underlying bond charges and interest on the First General 4 per cent Mortgage Bonds slightly exceeded this. Consequently the fixed charge on these First General Mortgage Bonds had to be reduced. This was done by giving the bondholder 75 per cent in new First General 4 per cent Mortgage Bonds and 40 per cent in 4 per cent Income Bonds. The holder of a $1,000 bond had his fixed income reduced from $40 to $30, but he was given an opportunity to receive $16 more if the earnings exceeded the interest on his own First General Mortgage Bonds. The exchange made the old fixed charge bondholder a partner in the fortunes of the reorganized Atchison system to the extent that he might be called upon to endure a loss of 25 per cent in his income in time of lessened earnings, while he stood in the position to gain 15 per cent in his income during periods of large earnings.

In refunding bonds bearing fixed charges into contingent charge securities, the question invariably arises as to whether preferred stock or income bonds should be used. The latter were very common during the reorganizations prior to 1893, because it was believed, probably rightly, that security holders would the more readily consent to give up bonds with a fixed claim on income, if they could receive new securities bearing the name of bond, even though the interest would be paid only if earned. It is a matter of name. A contingent charge security is not as attractive to the wavering investor if called a stock, as it would be if called a bond.[24] As the majority of the old income bond indentures provided that the interest should be paid out of net earnings only "if earned," the question arose periodically whether or not the accounting system employed by the management of the road gave a correct interpretation of net earnings. If, again, as was usually the case, the management controlled the common stock and was different in personnel from the income bondholders, then it was distinctly of advantage for the management to represent the earnings to be low, by unusually liberal maintenance charges. By this means money otherwise payable to the income bondholders and forever lost to the railroad, could be used to build up the property to such a point that the income would justify payments on the common stock quite as well as on the income bonds.[25] Invariably a controversy would arise.[26] As a result of the unfortunate experiences with income bonds, and the possibilities of trouble they involved, it gradually

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[24] This was discussed at some length, Volume I, Chapter IV, pages 82 to 87. See Daggett's observations, note 27.

[25] Mead put the whole matter with admirable clearness when he said: "The security of the income bondholder is the willingness of a board of directors which he has had no share in the choosing, to pay over to him sums of money which they have a perfect right to expend on the improvement of the property, a task which is never completed." Mead, E. S., "The Reorganization of Railroads," 17 An. Am. Ac. Pol. Soc. Sci., 235 (1901).

[26] One of the most interesting controversies of this kind arose in connection with the income bonds of the Central of Georgia Railroad. This road had its origin in a reorganization of the old, long-established Central of Georgia Railway in 1895. As a result of the reorganization, the company was burdened by three

became the accepted practice in the many railroad reorganizations following the panic of 1893, to use preferred stocks

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issues of income bonds, preceding a relatively small issue of stock. This is shown by the financial plan (small underlying issues not specifically mentioned):

Mortgage Bonds (fixed charges):		
Prior Lien	$1,840,000	
General Mortgage	7,000,000	
Consolidated Mortgage	16,500,000	
Total Fixed Charge Securities		$25,340,000
Income Bonds (contingent charges):		
First Preference, 5% Non-Cumulative (Interest to be paid if earned)	$4,000,000	
Second Preference, 5% Non-Cumulative (Interest to be paid if earned, after the first preference)	7,000,000	
Third Preference, 5% Non-Cumulative	4,000,000	
Total Contingent Charge Securities		$15,000,000
Common Stock		5,000,000
Total Securities		$45,340,000

From this it will be observed that $5,000,000 common stock, possessing, in the years immediately following the reorganization, only a nominal value of a few dollars a share (the third income bonds were quoted at 7 per cent five years after the reorganization) controlled over $40,000,000 of securities. Obviously, it was for the advantage of the common stockholders to build up the physical condition of the road by deflecting earnings to betterments. This could be accomplished by surreptitiously charging such betterments to the ordinary maintenance accounts. As a result little or no margin would appear to remain, after the payment of fixed charges, to apply to the contingent charges on the three income bond issues. And as these charges were not cumulative, the management could gradually build up the road from money that ought to have been paid to the income bondholders.

This is exactly what was done. The earnings of a subsidiary steamship company were deflected to capital account, the maintenance charges were increased to an amount well above those of other southern roads and far above the average for the country as a whole. During 1907, by such a system of adroit accounting, the management had been able to pay 5 per cent on the first income bonds, 3.729 per cent on the second, and to show $32.95 as a remainder out of over $12,000,000 gross earnings. Court proceedings were brought against the management to force the admission of secret earnings, and the payment of the full interest on all the income bond issues. The following was the court's finding:

Net earnings, after fixed charges admitted by the railroad	$461,030
Additional net earnings, added by the court:	
Earnings of the subsidiary steamship line that should have been paid to the railroad	544,399
Excessive reserve for unadjusted claims on lumber freight	100,000
Excessive maintenance	240,110
Minor adjustments, credit	81,223
Minor adjustments, debit	*102,828*
Total net earnings available for income bond interest	$1,323,934
First, second, and third income bond interest	750,000
Surplus available to common stock	573,934
Equivalent to	11.4%

This decision was rendered in 1910 and referred to the year 1907. Meanwhile, in June, 1909, the Illinois Central Railroad had acquired the common stock and had made the Central of Georgia its southeastern connection. In view of the decision something had to be done to settle the threatened prolonged litigation with the income bondholders concerning the interest before and after 1907. Accordingly the Illinois Central provided the Central of Georgia Railroad with $15,000,000 in money, by means of which all three issues of income bonds were retired at par and took in return 6 per cent Cumulative Preferred Stock of the Central of Georgia at par. Further details, up to the time of the court decision, see

instead of income bonds for the contingent charge security.[27] Unfortunately[28] this wise procedure has not been followed alto-

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Dewing, A. S., "The Position of Income Bonds, as Illustrated by those of the Central of Georgia Railway," 25 Q. J. E. 396 (Feb., 1911).

In the reorganization of the New York Railways Company (the surface car lines of New York City) certain adjustment or income mortgage bonds were created which should receive interest only if earned. The company, in order to hold back earnings, created a "Reserve for Injury and Damage Claims" account and charged large sums to it. The managers of the company did not create any such account in the books of other traction companies operated in New York City, nor was such an account required by the Public Service Commission of New York, First District, under which the company operated. See report of Cobb, Augustus S., November 18, 1914.

See also Volume I, Chapter IV, note 56.

Mindful of the possible trouble that would arise when the net earnings were held back from the income bondholders, certain recent income bond indentures have striven, by ingenious provisions, to avoid future controversies. For example, in the recent reorganization of the Atlanta, Birmingham and Atlantic Railroad, an income bond issue was created to fund the receivers' certificates. In the indenture it was provided that the income bonds "bear interest payable annually or semi-annually at such rate, not exceeding 5 per cent per annum, as may from time to time be declared by the Board of Directors, but such interest shall be paid only in case there shall be net income of the railway company available for that purpose, as the term 'net income' may be defined on the rules and regulations of the Interstate Commerce Commission, as from time to time in force. The interest on the income bonds shall not be cumulative. The Board of Directors may, however, reserve in any fiscal year from such 'net income' an amount not in excess of 20 per cent of the net income of the railway company, or in any event in excess of $100,000 in any fiscal year. The total amount so reserved and at any time unpaid, shall not exceed, exclusive of interest, $300,000 in the aggregate. All amounts so reserved shall be carried to a fund to be designated 'Income Bond Reserve Fund,' which shall constitute a corporate liability and carry interest at the rate of 6 per cent per annum, with semiannual rests. The income bond reserve fund may be distributed to the income bonds in the discretion of the Board of Directors at any time and in any amount, but if in any fiscal year, while there shall be any amounts carried in the income bond reserve fund, there shall be any net income of the railway company in excess of (1) the amount required to pay the full interest upon the income bonds for such fiscal year, plus (2) an additional amount equal to 20 per cent of the net income of the railway company, but not in excess of $100,000, then any such excess (not exceeding the amount then in the income bond reserve fund) shall be paid over by the railway company to the trustee, for distribution to the holders of income bonds, upon the next ensuing interest date, and the income bond reserve fund, upon such payment, shall be reduced by the amount thereof. Any and all amounts in such income bond reserve fund, with interest, at the date of maturity of the income bonds, shall be paid over to the trustee for the benefit of the holders of such bonds. No dividends shall be declared on any stock of the railway company of any class, unless, at the time of such declarations, all amounts in the income bond reserve fund shall be set aside for distribution to the income bonds, and no such dividends shall be paid unless the amount so set aside shall have been paid to the trustee, for payment to the holders of the income bonds upon the next succeeding interest date. Failure to make any such payments shall constitute default under the mortgage securing the income bonds, on the happening of which, the principal of such income bonds may become or be declared due." Printed letter of E. T. Lamb, dated Dec. 15, 1915.

[27] Only one of the great reorganizations of the nineties used income bonds—the Atchison, Topeka and Santa Fé—and then a preferred stock was used in addition. Daggett made a statistical study in 1908, covering a selected group of reorganizations, including some occurring before 1893 and some in the years immediately following. He stated: "It will be noted that income bonds were more used before 1893 (than after 1893) owing probably to the fact that the name of bond was considered to increase the salability on the market. The use of income bonds has declined as a more accurate knowledge of their limitations has become widespread." Daggett, S., Railroad Reorganization, 366 (1908).

[28] In 1910 the writer made the following observation in another connection, and the largely increased use of income bonds in connection with recent reorganizations has strengthened his original judgment. "They [the income bonds] have

gether of late,[29] and one notes with regret an increasing tendency to ease the friction at the time of reorganization by a liberal use of income bonds. That it accomplishes the result is undoubtedly true, but that it sows seeds of trouble for the future is also undoubtedly true.[30]

Another tendency, too, that has crept into reorganization practice of recent years, is the use of cumulative instead of non-cumulative preferred stocks, where preferred stock is used as the contingent charge security.[31] Here, again, the cumulative feature of the contract is added in order to make the contingent charge security more attractive to the old bondholder who is asked to refund his fixed interest-paying bonds into a preferred stock. Although by no means as objectionable as the income bond, the cumulative feature may impose an unwholesome burden on the new corporation during the period of its rehabilitation, if the management feels under obligation to meet the preferred dividends out of scanty

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proved undesirable from the point of view of the investor because he is not a true creditor in the ordinary sense that a bondholder is, yet at the same time he has no voting power such as that exercised by the stockholder. His interests are in continual conflict with those of the other security holders. The income bonds have also proved undesirable from the point of view of the road and for the following reasons: (1) The continual dispute between the management and the income bondholders disturbs any possible harmony of interests and management. (2) This dispute injures the general credit of the road. If the income bondholders have their way, it becomes difficult to build up the road by liberal maintenance appropriations, and as far as capital expenditures are concerned the road finds it difficult to persuade the income bondholders to allow the directors to issue new mortgage or debenture bonds which shall have a prior claim on the earnings—thereby any legitimate expansion and improvement of the road is hampered. (3) And lastly, the presence of income bonds is now accepted as a confession of financial weakness at some time in the immediate past." 25 Q. J. E., 405.

[29] An interesting and on the whole vicious "compromise" practice has crept into use of late. It is that of making a bond issue a contingent charge up to a certain date and a fixed charge thereafter. One of the most striking cases of this character is that of the bonds to be used in the reorganization plan of the Northern Electric Railway of California. The plan was filed May, 1918.
Class A bonds—Interest a fixed charge, beginning July, 1917.
Class B bonds—Interest to be paid "if earned" up to July, 1919, thereafter interest fixed.
Class C bonds—Interest to be paid "if earned" up to July, 1922, thereafter interest fixed.
Class D bonds—Interest to be paid "if earned" up to July, 1927, thereafter fixed.
An instance in which an effort is made to protect the income bonds against future general obligations is afforded by the "adjustment bonds" of the Seaboard Air Line Railway (see note 37).

[30] This increasing use of income bonds was also noted with regret by Daggett in a recent periodical article. Daggett, S., "Recent Railroad Failures and Reorganizations," 32 Q. J. E., 446 (May, 1918).

[31] Discussed at length, Volume I, Chapter VI, page 124.

earnings.[32] For this reason the dividends are often made cumulative only after a period of two or three years.[33]

The third class of security to be considered in a comprehensive reorganization is the heterogeneous mass of junior securities subsequent in position to the general first mortgage bonds. They may include the consolidated and refunding mortgage bonds, the debentures, and the short-term notes. It is at this point that the greatest saving in fixed charges is invariably made, for the reorganization plan always provides that these bonds shall be changed, in large part at least, into income bonds or preferred stock. The accomplishment of this, however, in actual practice involves delicate problems of adjustment. On the one hand, the volume of these contingent charge securities offered in exchange for the junior liens, debentures, and notes, must be sufficiently liberal to induce the holders to accept the exchange, else they will obstruct the course of the reorganization or force the committees to purchase their interest, however small it may appear to be; on the other hand, the volume offered must not be so large as to absorb any equity remaining to the stockholders, else the latter will not accept the reorganization plan and the requisite new money will not be forthcoming. Between this Scylla and Charybdis, the reorganization committee must steer

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[32] The same view is taken by Daggett in his summary of recent railroad reorganizations. "From the point of view of reorganization technique two matters seem to deserve emphasis in this rapid survey of recent railroad experience in finance. The first is the increased use of preferred stock with rights to cumulative dividend, and the second is the considerable reliance upon the cumulative income bond. No less than nine examples of these two classes of securities are outstanding. Indeed, they account for a considerable part of the saving of fixed charges. . . . This practice, however, has little to commend it. Railroads are to some extent protected by it against formal bankruptcy, yet such formal bankruptcy is often better than the piling up of a huge load of unpaid dividends before a worthless and speculative common stock." Daggett, S., "Recent Railroad Failures and Reorganizations," 32 Q. J. E., 483 (May, 1918).

[33] The new 5 per cent Preferred Stock of the Missouri Pacific Railroad became cumulative about a year after the reorganization. This is unusual. On the other hand, in the Hudson and Manhattan tunnels reorganization, there was issued a large amount of 5 per cent Income Bonds the payments on which were non-cumulative for seven years from 1913 to 1920 and cumulative thereafter until payment in 1957. Ordinarily, however, the dividends or the interest remain non-cumulative for a shorter time—about three years in a considerable number of cases.

its course. And the matter is to be decided solely on the basis of the exigencies of the situation. If the failure is very serious, as in the case of the Pere Marquette, not only are no fixed charge bonds given for this level of junior bonds, but the holders are required to pay an assessment and take, altogether, only preferred and common stocks in the new company; [34] whereas if the failure is not so serious, these bondholders may even be given a small proportion of their lien in new fixed charge securities. This was the plan followed in the other recent comprehensive reorganization, that of the St. Louis and San Francisco.[35] Ordinarily, however, judging from the comprehensive reorganizations of the later nineties, the holders of these junior securities have been neither assessed, nor given new fixed charge bonds. They have been asked to accept, par for par, a preferred stock or an income bond. In this way, the refunding process involves no change whatever in the gross capitalization of the road, but does involve the total extinction of the fixed charges previously carried by them. In fact, it is true to say that the major

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[34] In the comprehensive reorganization of Pere Marquette (assessments described in Chapter V, page 113, and exchange of securities on pages 141 and 142 of this chapter) there were three layers of these junior bonds above the preferred and common stock. Only the uppermost layer ($14,000,000 Refunding Mortgage 4's of 1955) was offered the privilege of exchange—and this into common stock. The two lower levels ($2,000,000 Collateral Trust Notes and $5,000,000 Debentures) were treated exactly the same as the old preferred and common stocks. That is they were assessed 9¾ per cent and given 10 per cent in new first preferred and 20 per cent in new common stock.

[35] There was only one bond issue on this level to be dealt with in the last reorganization of the St. Louis and San Francisco—the $70,000,000 "General Lien" 5's of 1927. These bonds were given 25 per cent in new Prior Lien 4's (the premier security of the reorganized road), 25 per cent in First Income 6's and 50 per cent in Second Income 6's. Although extremely doubtful, still there was a possibility that, even with proper maintenance, something had been earned on these bonds. An allowance of 25 per cent in principal and 20 per cent in fixed income return was an acknowledgment of this possibility.

The extensive use of income bonds—with the interest charges cumulative—was a very serious defect in the St. Louis and San Francisco reorganization plan. Trouble is bound to arise later, if the interest is not paid on the two income bond issues. If it is paid, the reorganization has accomplished next to nothing of permanent value. It relieved a temporary crisis; it did not remedy the numerous serious and unintelligent blunders in the past financial management of this particular railroad. If it is not paid, litigation is bound to result. The experience of the Central of Georgia, with its three issues of income bonds, is distinctly parallel (see note 26). The plan evolved by the managers of the St. Louis and San Francisco reorganization lacked both in boldness and breadth of understanding; it showed none of the penetrating intuition and daring of execution that marked other recent American railroad reorganization plans.

reduction in fixed charges at the time of a comprehensive reorganization of a railway occurs on these levels of junior bonds.

From this analysis, it is possible to summarize the practical expedients in current use for reducing the fixed charges at the time of a thorough and comprehensive railroad reorganization. The old underlying and divisional bonds are refunded into one blanket issue, bearing a lower rate of interest. The ratio of exchange is determined in each case according to the earning power and strategic position of the property covered by the lien. On this level there is little reduction in fixed charges. The general first mortgage bonds are refunded into new general mortgage bonds, with ordinarily some slight saving in charges—the relative amount depending on the margin, if any, of net earnings available to the old general first mortgage bonds. All the bonds junior to these first mortgage bonds are refunded into a contingent charge security, involving the total extinction of fixed charges. It has seemed worth while to describe, in considerable detail, the treatment of different classes of securities in typical reorganizations of Class I, because the practices followed in other reorganizations are only modifications of these.

The methods of reducing the fixed charges in reorganizations of the second class—superficial reorganizations following temporary embarrassment or less serious failures—are far less drastic than those just described. As the failures of this class are less serious, so the sacrifices demanded of the security holders are less serious. The reorganizations are less penetrating; they affect only the superficial layers of the financial structures.

In a reorganization of this class the underlying and first mortgage bonds are in no way affected. The railroad, both in the period before the crisis and during the receivership,

fully earned the interest on these bonds. But this is not true of the junior securities. The interest on these was not earned and the necessity of paying it precipitated the crisis. At this level, and only here, it is expedient and just to demand a sacrifice. Accordingly, the holders of these junior bonds are asked to refund them into contingent charge securities—income bonds or preferred stock. This involves the total extinction of the obligatory interest.[36] These junior bonds, together with the stocks, are the only securities disturbed in a reorganization of this kind. And the new preferred stocks or income bonds given in exchange are quite as valuable as the old junior bonds, considering the decreased earnings of the road, so that little real sacrifice is asked of any of the bondholders.

Within recent years there have been three typical reorganizations of this class among important railroad systems. They were the last reorganization of the Wabash in 1915 and the reorganizations of the Chicago, Rock Island and Pacific, and the Missouri Pacific in 1917. The plan adopted was exactly the same, except for individual peculiarities and unimportant details. The underlying and divisional bonds were undisturbed. The general first and second mortgage bonds were undisturbed. In each case the decrease in fixed charges was brought about by refunding one or more issues of junior bonds into a preferred stock, having a position just one step inferior to the security given for the stockholders' assessments. That is, the uppermost layer of bonds was refunded into a medium-grade stock. Absolutely nothing was done to disturb any of the other layers of bonds.

Often, among failures of this second class, the conditions

[36] As observed in connection with the contingent charge security used in reorganizations of Class I (page 148), there is a growing tendency to make the dividends cumulative instead of non-cumulative. But in deference to the important principle that a railroad should be given a reasonable time in which to recover from its crisis, without a needless drain of capital charges, the cumulative period of the dividends usually begins some years after the reorganization. This practice was observed in the majority of the recent reorganizations of Class II.

are not sufficiently serious to warrant even a forced or involuntary reorganization. A kind of "capital adjustment" is considered sufficient, the object of which is merely to reduce or extinguish some particularly burdensome fixed charges. Often, in such cases, the owners of the upper level of fixed charge bonds consent to exchange them for an income bond or preferred stock. That is all there is to the "adjustment"; a fixed charge on a portion of the funded debt becomes contingent and the immediate occasion of bankruptcy is thereby averted.[37]

The method for the reorganization of railroads of Class III, the small local roads, is based almost invariably on some sacrifice from the holders of the first lien security. The financial structure of these small roads is usually very simple —first mortgage bonds and common stock. As the failure is not admitted until after the last shadow of value has disappeared from the stocks the full brunt of the reorganization must fall on the shoulders of the owners of the first mortgage bonds. To all intents and purposes the first mortgage bondholders take nominal and actual possession of what property remains. In a great many such cases the old common stock is not given an opportunity to enter the reorganization, even through the payment of a considerable assessment.[38]

In a few special cases of reorganizations of Class III

[37] A case perhaps intermediate between "capital adjustment" and "reorganization" is the voluntary rehabilitation of the financial structure of the Seaboard Air Line Railway which followed exactly the plan outlined above. Being a voluntary adjustment, consummated without the coercive power of the courts, little help could be obtained from the stockholders. For that reason no attempt was made to levy assessments, and the old stock was undisturbed. The crux of the entire matter consisted of a refunding of an issue of $6,345,000 of General Mortgage 5 per cent Bonds, with their overdue interest, into income bonds. These income bonds were specifically protected by a clause to the effect that no general credit obligations issued thereafter could have a priority of income over the income bond interest.

[38] Eleven recent typical reorganizations of Class III were studied. In ten of the eleven cases the old common stock was entirely wiped out. They represented the following: the Atlanta, Birmingham and Atlantic; Buffalo and Susquehanna (see next note); Cincinnati, Indianapolis and Western; Detroit, Toledo and Ironton; Gulf, Florida and Alabama; New Orleans, Mobile and Chicago; New Orleans, Texas and Mexico; Oklahoma Central; Wabash Pittsburgh Terminal; Western Pacific. The one of which this was not true, the Western Maryland, was a voluntary reorganization.

these observations do not hold true. These are the failures which can be attributed to specific and easily remedied causes —such as unnecessarily burdensome traffic contracts or unprofitable leases—which can be changed by the receiver as soon as he comes into control of the property. In such cases the earnings during the receivership and anticipated earnings after the receivership are so much larger than the earnings during the past that the old stockholders (particularly the preferred shareholders) can claim, with a show of justice, that some equity remains to them.[39]

Such cases are, however, rare. By far the vast majority of the reorganizations of these little railroads turn upon radical sacrifices by the bondholders. As the failure is not admitted until conditions are very serious, the receiver is forced to issue receivers' certificates immediately. By the time the reorganization occurs, it happens not infrequently that about all the value of the railroad, as evidenced by its earning capacity, is limited to these issues of receivers' certificates. Consequently, when the road is actually reorganized, the burden falls back on the shoulders of the holders of the first mortgage bonds, provided they wish to retain any equity above the receivers' certificates. In extreme cases, even, the holders of receivers' certificates may be called upon to make a considerable sacrifice in order to permit the railroad to continue in operation. As a whole the crux of the reorganization is not so much a question of the reduction of fixed charges—such a reduction is admitted without argument even to the extent

[39] A thoroughly typical case of a reorganization of a Class III road following just this plan is that of the Buffalo and Susquehanna Railroad. This road was built in the middle nineties to reach certain coal fields in northern Pennsylvania. It was fairly successful. In 1907 the Buffalo and Susquehanna Railway, the connection to Buffalo, leased the Railroad. The Railway defaulted on its rental in 1910, and the Railroad soon after defaulted on its bond interest. A receiver was appointed for the Railroad, who, through excellent management, proved that the Railroad alone, without the Railway, was a successful enterprise. In the reorganization, the bondholders were merely asked to surrender 30 per cent in principal and interest of their bonds, in return for a bonus of 30 per cent in preferred and 15 per cent in common stock. A small amount of money was raised through assessments on the old preferred stock, but this was not an essential part of the reorganization, as the receiver had placed the road on an established and profitable basis.

of refunding the first mortgage bonds into stock—but is rather a question of the amount of assessments that can be successfully levied on securities possessing at most only a nominal value. This was treated more at length in the preceding chapter.

Aside from the reduction in the interest on the bonded debt, a considerable saving in fixed charges can be brought about in all types of reorganization through the cancellation of burdensome leases and operating contracts. Unremunerative leases have been, throughout all railroad history, a considerable factor in the explanation of financial misfortunes. Of the 25 leased lines belonging to the old Wabash system at the time of its failure in 1884, only three were meeting their expenses. For a period of six months following the receivership the deficit on the 22 amounted to over $1,000,000, while the profit on the other three—including the very valuable Chicago division—amounted to only $100,000.[40] Other instances of a similar nature can be found in the history of early reorganizations.[41] And even within recent years the specific cause of many railroad failures has been the weight of burdensome leases. The receivership of the St. Louis and San Francisco Railroad in 1913 was largely due to the overpowering burden of the Chicago and Eastern Illinois lease. Similarly the receivership of the Toledo, St. Louis and Western Railroad in the following year came, in no small measure, from the guarantees involved in the acquisition of a controlling interest in the Chicago and Alton.

[40] 40 Chron., 427 (April 4, 1885).

[41] The first notable case of American railroad receivership was that of the Vermont Central in 1855, brought about by the fact that the road had leased another, the Vermont and Canada, in 1850 at a conspicuously high rental. The case remained before the courts for 29 years owing to the difficulty of straightening out the rights of lessor and lessee. For further information, see Report of Joint Special Committee to Investigate Vermont Central Management, published at St. Albans, Vt., 1873. Brief summary of the legal difficulties, Thompson, "Court Management of Railroads," 27 Am. Law Rev., 491 (1893), where references are given to the Vermont court records covering the case. Also 23 Am. Rd. Jour., 665. This is a famous case from many points of view—legal, historical, economic, and social.

At the time of receivership the court or its receiver may determine which of the various leases, almost invariably a part of the growth of a great system, are to be retained.[42] This need not be done immediately.[43] But having determined to retain an old lease or contract and receive benefit from it, the receiver cannot subsequently refuse to meet the charges.[44] In the earlier practice it was considered at least unwise, possibly transcending the power of the court, for the receiver to enter upon new leases in such a manner as to burden the property under his charge with new obligations. Latterly, however, owing to a more liberal interpretation of the powers or rather the obligations of efficient management that the receiver assumes, it is generally recognized that he may execute new and permanent leases if it seems to the interest of the railroad and the public.[45] In all the more recent railroad receiverships, especially since that of the Baltimore and Ohio in the middle

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[42] It seems to be a well-established principle of law that the receiver may use his discretion as to which contracts he continues and which he repudiates. In an early decision, Wells, J., stated the position briefly. The receivers "may fulfil the contracts of the corporation so far as beneficial. They will not pay its debts, nor fulfil contracts which are burdensome or tend to diminish the value of the property in their control, unless such contracts are charged as encumbrances on the property or are necessary to its proper preservation and security." Ellis v. B. H. & E. R. Co., 107 Mass. 1, 28 (1871).

This view is supported by Chief Justice Fuller, in the leading Wabash case (145 U. S. 90), who quoted with approval a rule laid down by the Supreme Court shortly before. "Upon taking possession of the property, he [the receiver] was entitled to a reasonable time to elect whether he would adopt this contract and make it his own, or whether he would insist upon the inability of the company to pay, and return the property in good order and condition paying, of course, the stipulated rental for it as long as he used it." S. O., etc. v. Wilson, 142 U. S. 313, 322 (1891).

[43] In the Chicago, Rock Island and Pacific Railway receivership of April, 1915, the court gave the receivers six months to determine which existing contracts and leases would be continued and which repudiated.

In rare instances a decision on an important contract must be reached almost immediately after the receivership, else the unity of the railway system will be jeopardized. Often a compromise is effected, which merely continues on a contract.

The St. Louis and San Francisco Railroad passed into the hands of receivers May 27, 1913. On October 1, 1913, an issue of $2,880,000 of the Ozark and Cherokee Central Railway First 5's fell due. These bonds had been assumed by the St. Louis and San Francisco in 1907, but the receiver declined to meet the principal.

Accordingly an agreement was consummated between the receivers of the St. Louis and San Francisco and a large majority of the bondholders. This provided: (1) the bondholders would not institute any foreclosure suit; (2) the receivers agreed to pay 5 per cent on the principal of the overdue bonds and to expend, in addition, $10,000 a month for improvements on the lines covered by the bonds.

[44] Cen. Tr. Co. v. Ohio C. R. Co., 23 Fed. 306 (1885). Apparently, although the lease is maintained, the receiver cannot be made to pay more than the net earnings of the leased property. 105 U. S. 278, 287 (1881); 198 Fed. 721, 730 (1912).

[45] Farmers Loan & Tr. Co. v. Easton, 114 Fed. 14 (1902).

nineties, the receivers have canceled old leases and entered upon new ones with almost the same freedom as an ordinary railroad management elected by stockholders. And in the final plan of reorganization these acts of the receiver have to be fully considered. Quite often the new railroad management, in its turn, seeks to reassume the old leases repudiated by the receiver and repudiate those made by the receiver. For these reasons the statistics covering the saving in fixed charges through cancellation of leases are not as conclusive as might be presumed.

Nevertheless, the cancellation of unproductive leases is an important gain in almost every reorganization. The leases of the St. Louis and San Francisco and Colorado Midland railroads, involving upwards of 1,400 miles of line, were repudiated in the Atchison reorganization of 1895. Had the lease of the former been retained, "the fixed charges of the Atchison system of 7,780 miles would have been increased from $7,000 to $9,000 per mile." [46] Similar large cancellations were made during or at the time of the Union and Northern Pacific receiverships.[47] On the other hand, it must be remembered that even though a lease may be unprofitable in itself the cancellation is sometimes a good deal more unprofitable. During the discussion following the receivership of the Boston and Maine, it was pointed out that the fundamental trouble with the road lay in its burdensome leases. Although this was true, certain of its subsidiaries, notably the Fitchburg, would be a great menace to the road if owned by a competing line. The inroad into Boston and Maine's earnings, if, for instance, the Fitchburg were to be leased to the Delaware and Hudson or to the Erie Railroad, would far exceed the possible deficit involved by a continuation of the old lease.

[46] 1896 At. Top. & San. Fé An. Rep.

[47] According to Daggett, the reduction in money rentals for the Union Pacific reorganization amounted to 88.9 per cent and for the Northern Pacific 78.2 per cent. Daggett, S., Railroad Reorganization, 370 (1908).

It is difficult to say to what extent the net fixed charges of railroads have been decreased through the cancellation of leases and traffic contracts at the time of reorganization. Mead estimates that for the reorganizations of the middle nineties these reductions amounted to nearly $25,000,000.[48] This estimate was undoubtedly too large. Furthermore the reduction, in many cases, is more apparent than real, because the leased line possesses an inherent earning capacity which has partially, if not entirely, met the rentals. If the earnings have been more than sufficient to meet the charges, then a cancellation, in spite of the nominal reduction in fixed charges, would stand for real reduction in net earnings. Because of this important fact, and because unprofitable leased lines are strategically necessary for the parent road, it is common for subsidiary roads leased prior to the receivership, to be consolidated with the parent road at the time of the reorganization, after which their charges become partially or entirely bond interest instead of rentals. In these cases, the net results to the road in reduction of fixed charges may be slight, although the apparent reduction in leased line rentals is very large.[49] This circumstance is brought out by Daggett's studies

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[48] The sources and basis of computation for this estimate are not disclosed. Mead says: "The owners of the leased line have no choice but to accede to the propositions of the reorganization committee for a reduction of charges. . . . The extent of the reduction in rentals from reorganization is seen when the reduction of this item of fixed charges for the entire country is considered. The net reduction in lease rentals from 1892 to 1898 was $24,527,000, and of this sum $17,768,000 appeared in the South and West, where the failures were more numerous and extensive. The reduction of rentals was most conspicuous in the Northwest and Pacific Coast railroads. It is true that a part of this decrease in rentals is to be ascribed to the steady movement in the direction of consolidation which is constantly converting lease into purchase, but coming so close together, the difference between the figures of 1892 and those of 1898 is sufficiently marked to warrant the conclusion that most of the reduction is due to the numerous reorganizations which intervened." Mead, E. S., "The Reorganization of Railroads," 17 An. Am. Ac. Pol. Soc. Sci., 228 (1901).

[49] For instance, in the Erie reorganization of 1895 there was, according to Daggett, a net reduction of rentals of 62.7 per cent, but this was largely offset by an increase of 33.3 per cent in net interest charges. Daggett, S., Railroad Reorganization, 370 (1908).

As an actual fact, a leased line which has never earned its rentals was acquired through the issue of prior lien bonds covering the entire system. The carrying charges on the bonds given in exchange actually exceeded the previous rentals. Ibid. 60, 72. Yet it must be remembered that this leased line was an absolutely necessary segment in the Erie's through Chicago line. Its absorption into the Erie system was in fact so necessary that the whole reorganization would have failed unless this link in the system had been acquired.

of the reorganizations of the middle nineties,[50] and it has been more or less apparent in all contemporary reorganizations involving the treatment of leased lines. It is of advantage, undoubtedly, in promoting the organic unity of the system, but it makes more difficult the separation of unprofitable branch and subsidiary lines.

The principles laid down in this chapter thus far concerning the reduction in fixed charges apply to voluntary as well as involuntary reorganizations, but with much less force. The cases have been so few that even an approximate conclusion based on reliable statistics is out of the question. Furthermore, the statistics covering voluntary reorganizations alone are not of great significance because of the shadowy lines of classification. What to one man is an unimportant capital readjustment is to another an important voluntary reorganization. Suffice it to say, however, that most reorganizations of the true voluntary form differ in no radical and significant characteristics from one or another of the involuntary types heretofore described. The most striking difference, between the voluntary and involuntary types, has been the marked tendency to leniency toward bondholders. This was perhaps more obvious before 1900 than since. Certain it is, however, that, except for a few notable exceptions, the bonded debt—although not necessarily the fixed interest charges—was increased in all the voluntary reorganizations down to 1897.[51] The fixed charges as a whole were probably somewhat lessened, although the small number of typical cases available for study makes any generalization of little value.[52] Since 1900 the data

[50] The apparent reduction in rentals for seven cases chosen by Daggett is 58.8 per cent. But there was a conspicuous increase in interest charges on bonds issued to acquire the lines previously leased. Consequently the net decrease in fixed charges amounted to only 25 per cent. Daggett, S., Railroad Reorganization, 370 (1908). (See also note 56.)

[51] Meany's statistics. Poor's Manual of Railroads (1900) Introduction.

[52] Using six of the most important voluntary reorganizations, it was found that the average decrease in fixed interest charges was 13 per cent, but of these six cases two showed a distinct increase. Decrease—Chesapeake and Ohio of 1888,

available do not permit of even tentative generalizations.[53]

It has been pointed out by all the writers on railroad finance, that every railroad reorganization, at least until the last few years, involved an increase in the nominal amount of securities.[54] The reason was that in order to induce the holders of junior bonds and stock to undergo sacrifices, they must be placated by liberal bonuses of well-nigh worthless junior securities of the new road. "As a result of the shifting of securities the majority of railway companies emerged from reorganization burdened by an increase in capitalization. . . . Reorganization acted as a drug to tide over a period of weakness—the future was mortgaged to satisfy the present.[55] This view, perfectly justified by the data available from all the railroad reorganizations down to 1912[56] is not true of con-

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Missouri, Kansas and Texas of 1890, the Reading of 1888 and the Atchison of 1889. Increase—the Reading of 1882, and the Baltimore and Ohio of 1898. The largest proportionate increase of any case coming to the writer's attention is that of a small road, the San Antonio and Aransas Pass, in which the increase amounted to upwards of 90 per cent.

[53] Of the recent reorganizations studied by Daggett, four may be considered as voluntary. One, the Chicago Great Western, showed a radical increase in fixed interest-bearing securities. The other three showed a decrease. Daggett, S., "Recent Railroad Failures and Reorganizations," 32 Q. J. E., 468 (May, 1918).

[54] Probably stated first in the form of a general principle of reorganization procedure as far back as 1890 by Simon Sterne in a periodical article entitled "Railway Reorganization," 10 Forum 44 (1890). In some form or other it has been repeated by practically every financial writer on railway reorganizations down to within the last five or six years. For statistical studies, see note 56.

[55] 25 Q. J. E., 396 (1911).

[56] The most inclusive study is that of Meany, dealing with a list of 313 cases of railroad reorganizations between 1884 and 1900. This study was printed at length as a part of the introductory matter to the 1900 edition of Poor's Manual of Railroads. Detailed computations supporting the figures in this note are to be found there. Meany believed that his list comprised all the completed reorganizations during the period. Of the entire number, 297 represented involuntary reorganizations. Taking into consideration a slight increase of railroad mileage, we may safely conclude, from these figures, that there was a decrease of at least 18 per cent in the bonded debt. The actual decrease in fixed charge securities was considerably greater, since Meany included the income bonds in the bonded debt. On a mileage basis the bonded debt fell from $39,600 per mile to $34.200 per mile, allowing for the changes in the length of line. On the other hand, the stock showed an increase of 17 per cent, rising from $31,700 per mile before reorganization to $38,000 after reorganization. Altogether the total capitalization showed an increase of a little less than 4 per cent, or less than $3,000 per mile. If the involuntary reorganizations alone are considered, the reduction in the bonded debt is more marked, but in other respects the results are approximately the same.

In addition to this general study, Meany investigated two random selections of reorganizations; one comprised 57 involuntary reorganizations, the other included 68 cases, a few of which were important voluntary reorganizations. With the former there was shown a reduction of 33 per cent in the total bonded debt and an increase of 29 per cent in capital stock. In the second collection of cases, the fixed charge

temporary reorganizations.[57] The tendency since 1910 has been to so plan reorganizations as to effect a reduction rather than an increase of the net capitalization. Especially is this true if the old floating debt, which is funded by the reorganization, is included in the computation. The temptation to issue excessive amounts of junior securities no longer exerts a malign influence. The state railroad commissions have not countenanced the unbridled issue of junior securities, stockholders show a more intelligent discrimination between nominal and real value, and the era of railway promotion, with its exaggerated promises of future earnings, has passed. The railroad business is fighting now to retain what earnings it has; it no longer cuts its financial pattern according to the fabulous earnings of an unattainable future prosperity.

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securities and the stocks were not shown separately, but the total capitalization showed an increase of approximately 12½ per cent.

These statistics of Meany do not conform to those obtained by Daggett. Using 7 selected cases of reorganizations since 1893, Daggett discovered a reduction in bonded debt of only 4 per cent, while 7 cases of earlier reorganizations showed an actual increase of 22 per cent. His table does not permit a separation of the involuntary from the voluntary. Daggett also found an average increase of total capitalization of 30 per cent for 6 involuntary reorganizations after 1893. Daggett, S., Railroad Reorganization, 363, 373 (1908). Apparently Meany's cases show a conspicuous decrease in bonds with less change in total capitalization, whereas Daggett's show little change in bonded debt and a marked increase in net capitalization. Daggett's cases are probably too few to be of general value, whereas the complete list of Meany's 313 cases included too many insignificant local reorganizations to be of general significance. Considering the diversity and care of selection, the results shown by Meany's 57 cases are probably the most reliable evidence we have. This compilation and that of Daggett agree in concluding that the total net capitalization was increased 30 per cent.

[57] For example, the old capitalization of the Pere Marquette Railroad, prior to the reorganization of 1915, was $113,500,000 not including the overdue interest. The reorganized Pere Marquette Railway was capitalized, altogether, for $105,000,000 and this included the new money paid in at the time. This is the typical Class I reorganization used in the previous analyses.

In a recent study Daggett compared the total outstanding securities in 15 reorganizations. Daggett, S., "Recent Railroad Failures and Reorganizations," 32 Q. J. E., 469 (May, 1918). He found that the net capitalization was increased in 7 and decreased in 8 of the cases. The total capitalization of all the roads considered decreased less than 2 per cent. The most marked increases were represented by the voluntary reorganization of the Seaboard Air Line and the involuntary reorganization of the St. Louis and San Francisco. One may hazard the guess, however, that if the floating debt and subsidiary capitalization had been figured a little differently, the difference would not have been so marked. For example, the Missouri Public Service Commission (case 815, opinion and order, dated Dec. 22, 1915, page 22) reproduced the estimate of total net capitalization of the St. Louis and San Francisco given in the reorganization plan of November 1, 1915 (pages 30 and 31). Here it was shown that the reorganization effected a reduction in total net capitalization from over $350,000,000 to less than $330,000,000. The great difficulty with all reorganization statistics is to distinguish the items which should be included from those which should not.

CHAPTER VII

INDUSTRIAL REORGANIZATION PLANS

The methods that have been pursued in reorganizing industrial corporations have been analogous to those employed for railroads, but the general form and detailed structure of the plans differ markedly. This is because of the essential differences between railroads and manufacturing or mercantile enterprises. In their social status as public service corporations and from the similarity of their operation in furnishing a service and not a commodity, railroads are all alike. Industrial enterprises have little in common among themselves except the absence of those very characteristics possessed by public service enterprises. One class operates under the conditions of a protected monopoly, the other under conditions of free competition. There are no real monopolies of location in the industrial field, and whatever approach to monopoly can be discovered lies in the direction of control over patents or trademarks. Therefore the earnings of any single industrial must be subject to abrupt fluctuations due to changes in the general purchasing power of the community and to changes in the managerial ability exercised by the men in control. From the beginning their financial plan must therefore be based on

the presumption that the business can rely on itself alone in protecting its trade position, never on the community.[1] This fact is paramount in formulating any plan for reorganizing an industrial undertaking.

Most industrial corporations, because of the fluctuating character of the earnings, were organized without bonds.[2] For this reason many companies which have been, on the whole, unsuccessful, have been able to survive successive business depressions and single unprofitable years without ever meeting the necessity of reorganization. So long as they met the direct expenses of operation and possibly the preferred stock dividends, they could run along the even tenor of their way, however small their net earnings. The fact, therefore, that an industrial corporation has not been reorganized in no wise argues for its fundamental success.

Enforced reorganization of railroads has occurred, almost invariably, only after the actual or threatened failure to meet bond interest. Had the railroads been without bonds, few, if any, reorganizations would have been recorded. But such is the insecure position of many industrials, buying and selling in competitive markets, that reorganization has been necessitated by the mere losses incurred by their ordinary business transactions. Thus in the six months prior to the reorganization of the old Consolidated Cotton Duck Company into the International Cotton Mills Corporation, the former company endured a net manufacturing loss of $244,000 which was augmented by the payment of interest amounting to $575,000.[3] Many other industrial reorganizations have followed in the wake of conditions so unfortunate that, in spite of the fact

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[1] The competitive, in contradistinction to monopolistic, character of industrials has been repeatedly pointed out. See particularly the chapter dealing with financial plan to be followed at the time of the promotion of a manufacturing company—Volume II, Chapter IV.

[2] Ibid.

[3] Report of President, Consolidated Cotton Company for year ending December 31, 1909.

that bond interest was absent, the corporation could not meet the expenses incident to its ordinary business.

This suggests that general creditors of industrial enterprises are in a stronger position than the general creditors of railroads. Their liens are not ordinarily superseded by those of bondholders, nor is the practice of permitting the issue of receivers' certificates to take precedence over ordinary general creditors so often permitted by the courts.[4] The general creditors can, therefore, by threatening to liquidate the property of the company, force the stockholders to meet fully their claims.[5] On the other hand, the internal organization of an industrial company, being sometimes the most valuable part of the corporation's property, would be jeopardized should the old management surrender the corporate assets to the creditors and start a new and competing business of their own.[6] The creditors are thus at a disadvantage in dealing with them, in spite of the apparent security of their claims. In view of all these considerations one is less able than in the case of railroads to form even tentative generalizations. One cannot say, for example, that a temporary shortage of money and a permanent overburdening of capital charges will be found present as a condition precedent to every industrial reorganization as is the case in every railroad reorganization. Nor can one find sufficient grounds for the presumption that relief from a heavy floating debt and a reduction of fixed charges are the invariable consequences of every industrial reorganization. The most that can be said is that

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[4] *Infra*, page 104.

[5] This is well illustrated by the reorganization of the old United States Shipbuilding Company into the Bethlehem Steel Corporation, and more recently by the reorganization of the Allis Chalmers Company in 1913. Every dollar of current debt was paid, although both reorganizations were very drastic and in the former the preferred and common stocks were wiped out.

[6] Sometimes creditors have taken over a failed business and attempted to operate it. Such cases have usually resulted in still another and more serious failure. Thus in the reorganization of the old National Cordage Company in 1894, the creditors took entire control. This forced the old officers to start businesses of their own. In the weakened condition the reorganized company failed again in a year.

ordinarily in industrial reorganizations some new working capital is supplied and there is some readjustment of the forms of capitalization. And while this readjustment of the capitalization is likely to entail a lessening of the fixed charges, cases are by no means uncommon in which a reorganization burdened an industrial with new and increased charges.

Unlike railroads, industrial enterprises may ordinarily be liquidated if such a course seems expedient. Sometimes it is even expedient to liquidate a business before a critical condition has arisen, especially if a large part of its assets are easily salable. Yet, under the best conditions, the sale of corporate assets is bound to show losses as compared with their book value.[7] If the enterprise has little hope of success it will be best under all circumstances for those interested to recognize the fact and sell the property for what it will bring, even though the creditors will suffer considerable loss and the stockholders entire loss. Experience drawn from various enterprises that were reorganized several times in succession shows that, severe as would have been the losses at the time of the first reorganization, they were small compared to those endured by the men who continued to add new money at the time of each successive failure.[8]

The most conspicuous difference, however, between railroad and industrial reorganizations is the greater significance of the personal element in the latter. It was asserted in the opening paragraphs of the second chapter of this volume that

[7] Thus in spite of the readily marketable character of the stocks and bonds carried by the United States Express Company, that portion of the assets represented by equipment showed a net loss from book value of $367,516 during the first six months of the liquidation. At the same time a charge against assets of $548,000 had to be made to represent other liquidation debit charges, such as the charging off of organization expenses, the bonus paid for the cancellation of unexpired leases, rentals, etc.

[8] A single example illustrates this point. The original cordage consolidation was reorganized three successive times and the assets of the last company finally liquidated. Suppose $1,000 had been invested in its best security, a preferred stock, at the time the consolidation was formed. Such an investment would have sustained three separate assessments in the three reorganizations—$200, $120, and $31.50—aggregating $351.50. At the time of the final liquidation the securities held after having met these assessments had a realizable value of approximately $30. Details, see Dewing, A. S., Corporate Promotions and Reorganizations, 161 (1914).

human or psychological considerations were the most important and often the determining motives in all reorganizations. This assertion is conspicuously true in the case of industrial reorganizations, whether one considers the reorganization of a little village factory or that of a great enterprise, like the Westinghouse Electric and Manufacturing Company, with branches and affiliations all over the world. The popularity of the chief executive officers is able often to carry such weight with bankers that a plan of reorganization is accepted which otherwise would have been thrown aside; the dislike of business associates toward some man has often been the direct cause leading to a crisis in the affairs of a corporation with which he was connected and the ultimate acceptance of a plan of reorganization the main purpose of which was to eliminate him from the management. Jealousy always plays an important rôle. Personal likes and dislikes determine the lines of cleavage among the various interests directly affected and the strength of these lines of cleavage determines the plan of reorganization ultimately imposed on all concerned. These personal motives are seldom apparent on the surface, yet they exert a subtle influence at every turn in all industrial reorganizations.

If it is decided that the business shall be reorganized it is necessary to discover the causes of failure. As already pointed out in another connection, corporations do not ordinarily fail because of lack of working capital, but rather the appearance of a lack of working capital is an outward sign of fundamental difficulties.[9] The real cause of industrial failure is quite as little apt to be a difficulty of securing credit due to sudden tightening of the money market as in the case of railroad failures, although, if there is any opportunity, this cause will be alleged. As in the case of railroads,

[9] See Chapter II, particularly page 26.

the real reason underlying the difficulty in securing further bank loans is not the obstinacy of the banks but the impoverished credit of the company. Quite probably the corporation paid interest on debt and even dividends out of capital during the period prior to the acknowledged failure, although this interpretation of their action will be avoided by the directors.[10] Yet the fact will remain, whether cause or effect, that the failed corporation is in straits and requires more ready money. So that, as in the case of railroad reorganizations, the chief ends of industrial reorganizations are necessarily the removal of the underlying cause of the failure and the collection of new money. But in the case of railroad reorganizations, the underlying cause is usually connected with an excessive fixed charge. This is not always true with industrials, because many industrials in financial straits have been altogether without bonded debt. Consequently, although the purpose of collecting new money is invariably present in every industrial reorganization, the rest of the reorganization does not always turn about the problem of reducing the fixed charges. It may happen—in fact it often does happen—that the need for new money is so urgent that a new fixed charge is added because the sale of first mortgage bonds is the only means available to obtain new money. The stability of the future is sacrificed to meet the necessities of the present.

At the time of the reorganization free money is often obtained by the receivers indirectly by ceasing the payment of interest on debt or the principal of maturing obligations. If this is not ample, the receivers may be permitted by the court to issue receivers' certificates, although the reasons for the issue of these certificates must be more urgent and the amounts less liberal than in the case of railroads and public

[10] *Infra*, page 22.

utilities. The indiscriminate and reckless issue of receivers' certificates, which the federal courts have tolerated in recent cases of railroad receivership, is absent in the case of industrials. The courts have assumed that the necessities of the public do not require the continuation of the business at a loss to the creditors and stockholders. Whether or not receivers' certificates are issued, the problem for the reorganization managers is the same—to obtain enough new money to meet the outstanding debts of the old corporation and to supply the reorganized corporation with adequate working capital.

The simplest method of obtaining new money is to sell securities to outside banks. In this way the stockholders are not required to act individually nor to make conscious sacrifices,[11] except perhaps the mere consent to a new bond issue.

If no mortgage or other form of funded debt exists, bankers will frequently consent to buy a small issue of first mortgage bonds of the reorganized company on the assumption that the assets are at least sufficient to cover the debt. In such cases, it is common for bankers to insist that the new company maintain large fluid assets to further strengthen the bonds.[12] And even when the new company is able to show assets far in excess of the new debt, the difficulty lies in finding investment bankers who will consent to buy any securities whatever of an enterprise known to be on the verge of bankruptcy. Without regard to the fundamental security

[11] Experience has shown that it is both costly and provocative of controversy to induce stockholders of embarrassed industrials to make a direct sacrifice, such as the payment of any assessment. On the other hand, stockholders do not offer serious objection if new securities are placed ahead of their stock, although their sacrifice through the deflection of the actual and realizable value of their equity may be even greater than the amount of a reasonable assessment. It is another instance of the inertia of stockholders.

[12] Thus, when Blair and Company bought $2,000,000 par value of notes of the International Cotton Mills Corporation of New York, soon after the latter was formed out of the nearly bankrupt Consolidated Cotton Duck Company, the bankers insisted that the corporation should place no new mortgage on its property and that it should maintain its quick assets at least equal to its liabilities, including the $2,000,000 of notes. Agreement between International Cotton Mills Corporation and the Mercantile Trust Company dated July 13, 1911. Article 3.

of the bonds, bankers of high standing are unwilling to permit their names to be connected with enterprises likely to become notorious through repeated failures.

As a rule, therefore, bankers are willing to advance money to relieve a threatened or actual failure, only in those cases in which the embarrassment is to be traced to causes easily discovered and easily remedied. Future success then turns upon the question of management. To safeguard themselves against bad management and even a repetition of failure, and to give the corporation the advantage of their specialized knowledge, the bankers who do advance money under such circumstances always require that at least one of their associates be elected to the board of directors. It is quite usual for them to go even further and assume the actual financial administration of the new corporation. Furthermore, to secure this co-operation and to make the bankers' interest in the new company worth while the corporation may pay the bankers' commission partially or wholly in common stock.[13] Very frequently the greatest benefit resulting from the reorganization is the new moral support of the bankers and the general confidence which this support engenders. Their money is soon spent, but their co-operation remains. As a result of these considerations it may be said, in summary, that those reorganizations in which the new money has been supplied by independent bankers have followed, almost invariably, failures of the least serious sort. This is particularly true of failures attributable to some temporary emergency not likely to occur again—such as the sudden tightening of the money market or the immediate need for new equipment.

When the necessary new money cannot be obtained by such simple means as the sale of treasury assets or the quiet

[13] Thus in six industrial reorganizations examined in another connection which turned upon bankers' contribution of new capital, the bankers' commission was stock alone in four of the cases, stock and money in a fifth, and money alone in only one case.

sale of new bonds to outside bankers, it must be subscribed by the stockholders. This method, although perfectly fair, because the stockholders are the real owners of the business and should bear the burden, is found difficult to apply in practice because of the reluctance of stockholders to face the result of failure squarely. In deference to this feeling and to remove the taint of assessment, it is common to give to the stockholders a new contingent charge security in return for their money contributions. This usually takes the form of a preferred stock and is not likely to be as carefully safeguarded as the bonds which are sold to bankers. Yet no bonds are placed ahead of it, for otherwise the stockholders would not subscribe. If there is reason to suppose that the stockholders will not voluntarily submit to what is virtually an assessment, the directors may find it necessary to throw the corporation into the hands of receivers and submit to a judicial sale of its assets. In no other way can the non-contributing stockholder be eliminated. But, as in the case of railroads, this extreme method of coercion is both expensive in money and destructive to the credit and trade position of the corporation. It is resorted to only in extreme cases when the recalcitrant stockholder cannot be reached by all the arts of persuasion. The second Westinghouse reorganization of 1908 is notable in that no sale of the corporation occurred and the stockholders contributed a large amount of money, for which common stock only was given them. However forceful this exception appears, the fact remains that threatened loss of their entire investment is ordinarily alone able to wrest new money from stockholders.

An unusual but efficient and direct plan is followed by the Massachusetts textile mills when they find their credit impaired. The stockholders first authorize the reduction of the capital stock by a certain proportion, possibly 50 per cent. This involves the cutting of each stockholder's interest in half.

They then authorize the sale of the stock surrendered at par to either the old stockholders or outside bankers. The final result of these two steps is a substantial increase in the available money, without any increase whatever in either the amount of stock outstanding or the direct liabilities. This method has been applied in other reorganizations outside of New England but in a less drastic form.[14] Its advantages lie in its simplicity and the slight dislocation of the corporation's business which is likely to occur. It is merely a matter of sacrifice on the part of the stockholders to enable the corporation to strengthen its general credit.

Money can be obtained from bondholders only in case the funded debt is considerable and the apparent equity remaining to the stockholders comparatively small. If there are reasons to believe that the assets of the corporation can be liquidated or can be sold at judicial sale for an amount sufficient to cover the bonded debt, no pressure can be brought against the bondholders. They would prefer to "allow the law to take its course" rather than to contribute to the relief of the company. It is therefore only in cases of extreme embarrassment that help may be expected from the bondholders; and it follows from this that the worse the failure proves to be, the more the bondholders will be concerned in the reorganization. Yet even when no equity remains to the stockholders, and the corporate assets are less than the debt, it is usual to allow the stockholders to come into the reorganization on the payment of a heavy assessment in order to maintain the continuity of the business organization. Care

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[14] An excellent example of this type of reorganization possessing a more than local interest is the first reorganization of the Westinghouse Electric and Manufacturing Company in 1891. The company had grown very rapidly. As a result its unsecured debt had attained threatening proportions. The management conceived the wise plan of selling preferred stock to the creditors and outside bankers but were unwilling to merely increase the outstanding capitalization. Accordingly the Westinghouse Company proposed that the stockholders should surrender 40 per cent of their holdings to the company's treasury. The treasury stock thus obtained could be made preferred and sold for the benefit of the company. Great difficulty was experienced in persuading the stockholders to endure the sacrifice, although it saved the company from threatened bankruptcy.

must be taken, however, to ascertain either that this stockholders' assessment will be paid, or that the failure of the stockholders to respond will not jeopardize the success of the reorganization. When the stock of the old company is selling at a few cents a share in the market, it is evident that the stockholders will make little sacrifice to save it, and the bondholders would probably do well to reorganize the company alone without the tentative help of the stockholders. If more than one issue of bonds existed in the capitalization of the old company, some difficulty arises in apportioning the relative amounts which the different bondholders should contribute. Generally speaking, the underlying, senior bondholders can be relied upon but little, and most of the new money must be collected from the junior bondholders. Yet if the junior bonds are of little value, their holders will relinquish all interest in the reorganized company rather than pay any considerable assessment. In such a case the senior bondholders have no other alternative than to furnish the money necessary with perhaps slight help from the junior bondholders. Such a reorganization plan would follow only the most serious failure.[15]

Cases in which an assessment or money contribution is required of the outside creditors are very rare and are likely to occur only as a result of unusual circumstances. Either the outside debt is unsecured and there exist mortgage bonds which have a prior lien on essential assets—in which case the creditors are in a position analogous to the junior bondholders

[15] Many of these principles are illustrated by the reorganization of the Standard Rope and Twine Company in 1906. In this case the company had a small issue of First Mortgage Bonds (about $3,000,000), an issue of Income Bonds (amounting to $7,000,000), and a large issue of stock, together with a considerable floating debt. The reorganization required at least $1,000,000 in new money. The stock was worth nothing, the Income Bonds had slight value. The assets of the corporation were hardly worth the small issue of First Mortgage Bonds. In the reorganization plan the First Mortgage bondholders submitted to an assessment of 26½ per cent—abnormally large because the bond issue was small—but they could exact only an assessment of 5½ per cent from the Income bondholders. The stockholders were eliminated.

—or else they are impelled to assist the corporation from reasons of permanent self-interest.[16] In the former case they submit to the payment of a small assessment to enable the corporation to continue in business, knowing that if the assets were liquidated their claims could not be paid in full. As in all other cases, a money assessment is wrung from a class of security holders as the price paid for a chance to recover apparent losses.[17]

In the latter case the reasons of permanent self-interest are those of continued profit through enabling the corporation to continue in business. Many of the unsecured creditors have claims representing open accounts and merchandise notes, arising through the ordinary business relations with the failed corporation. These merchandise transactions have been a source of profit in the past, and the merchandise creditors have every reason to believe they will continue to be in the future—provided the business can be rehabilitated.[18] They

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[16] In connection with the status of outside creditors in industrial reorganizations it should be said that even federal courts are reluctant to apply the rule in Fosdick v. Schall, 99 U. S. 235 (*supra*, page 98), to industrial receiverships. Nor will the court ordinarily permit the issue of receivers' certificates to take precedence over mortgage bonds, the proceeds from the sale of which are to be used to pay bank or mercantile debts contracted before the receivership. In unusual cases the court may permit the payment of wage debts outstanding at the moment of receivership. Thus the receivers of the International Steam Pump Company were permitted by the court to pay certain wages and salaries for the month in which they were appointed on the presumption that the business could be maintained as a "going concern" only through the continued service of the more important officers and highly skilled employees.

The receivers of the Walpole Rubber Company, a small local rubber factory, were permitted to pay for several car-loads of coal received just prior to the failure, because only by paying for these cars could the receiver get the coal immediately necessary to maintain the operation of the plant.

[17] Thus in the original reorganization of the National Cordage Company, the unsecured noteholders submitted, practically, to a money assessment in taking 65 per cent of their claim in long-term bonds rather than forcing a settlement in cash. This was because the secured creditors were in a position to force the liquidation of the corporation's assets, in which case the unsecured creditors would be almost entirely wiped out. In consideration of this arrangement, the stockholders advanced money, taking in return only stock. This strengthened the obligations of the unsecured creditors. In other words, the unsecured noteholders could realize little by enforcing their claims; but by enabling the company to keep in business, through the further investment of money, they thought that they would stand a good chance of finally realizing on their claims. In this particular instance, however, they were disappointed.

[18] In the first Westinghouse reorganization, the merchandise creditors funded upwards of $2,000,000 of open accounts and notes into preferred stock, and in the second Westinghouse reorganization the merchandise creditors again funded over $4,000,000 of notes and accounts into common stock taken at its par value—distinctly higher than its market value.

are therefore willing to buy the long-time notes—or even the stock—provided there is reasonable assurance that the new company will purchase goods of them in the future.

If we turn from those aspects of the financial plan of industrial reorganizations having to do with the sources of new money to those dealing with the permanent changes in the capitalization, there is discernible even less ground for possible generalizations. It was already pointed out that the principle laid down in railroad reorganization, that the fixed charges were invariably reduced with the possible increase in total capitalization, does not hold true in the reorganization of industrial enterprises.[19] Not only may the total capitalization be increased by the reorganization, but that portion having fixed charges is as likely to be increased as not. In fact, one of the commonest means of relieving a company in financial difficulties has been to fund the current debt into first mortgage bonds, though the company may have had no funded debt before. The specific form of the reorganization plan is therefore determined by two independent sets of circumstances, the financial structure before the embarrassment and the seriousness of the embarrassment. As the financial structure of all our great railway systems is essentially the same, a classification of railroad reorganization plans could be made on the basis of the seriousness of the failure alone; but owing to the fact that this unity of financial structure does not prevail among industrials no such simplicity of classification is possible.

To get any logical order at all in the grouping of industrial reorganization plans, it is necessary to adopt another criterion. The one that seems to serve the purpose best is

[19] Of 23 successful plans of industrial reorganizations examined in another connection, 9 showed an increase of fixed charges, 10 showed a decrease, and in 4 cases the fixed charges remained unchanged. Dewing, A. S., Corporate Promotions and Reorganizations, 617, Plate A (1914).

that of motive. Accordingly we may deal with the subject on the assumption that there are three types of reorganization plans. The first is that in which the motive is to get relief from an accumulation of contingent charges on the preferred stock. These reorganizations might well be called mere capital adjustments. They are usually carried through in the interest of the common shareholders who would benefit from the extinction of accrued charges ahead of their stock; and to be successful the corporation must be in a fairly healthy condition, so that this type of reorganization is seldom resorted to in the presence of immediately threatened insolvency.

The second and third types, on the other hand, invariably follow failure or serious financial embarrassment. In the second type the crisis is immediately occasioned by a heavy, overpowering floating debt. Either by reason of lessened earning capacity or by reason of some other inherent weakness, the directors of the corporation find themselves able neither to continue nor to fund into bonds and stock the current maturing obligations. They are forced therefore to resort to some reorganization in order to continue the business. The third type of reorganization is analogous to the usual railroad reorganization. The failure is brought about by the attempt to meet the fixed charges on excessive bond issues or leased factories. The purpose of the reorganization, therefore, is always to reduce the fixed charges. The rest of this chapter is devoted to a discussion of these three types, but it must be admitted from the start that any classification of industrial reorganizations whatever is at best of value for simplicity of exposition rather than for anything indicative of fundamental differences. Furthermore, it should be remembered that any attempt to make an objective classification of industrial reorganizations on the ground of motive is vitiated by the simple fact that the primary motive is ordinarily personal. And this is difficult and sometimes impossible to

decipher. Human ambitions, feelings, and caprices are purposely clothed in the colorless and impersonal forms and phraseology of our commonplace financial jargon.

Those reorganizations of the first type, consummated primarily to relieve the corporation of an accumulation of unpaid preferred dividend charges, usually avow a balance of advantages to both preferred and common shareholders. They involve, ordinarily, some capital readjustment which brings the common stock nearer to the payment of dividends and turn, almost always, upon some modification of the preferred stock contract. The holders of this class of stock, knowing that their claim to unpaid dividends is indirect, and that they are powerless to enforce the payment no matter how large the earnings of the corporation may be, are usually willing to release their claim to dividends in return for some concession from the corporation. In rare instances only it amounts to the payment of the accumulated dividend in money.[20] It may take the form of: (1) the issue of a new higher dividend-paying preferred stock in exchange for the old cumulative preferred stock with its arrears of unpaid dividends; (2) a funding of the preferred stock dividend accumulations into new securities; (3) the funding of the old contingent charge preferred stock, with its accumulated dividends, into new bonds bearing interest charges lower than the dividend rate on the old preferred stock. All these methods have been used, and used with success. Invariably, the management, controlled by the common shareholders, represents that the plan to be adopted is of mutual benefit to all classes of security holders. In some cases it is, in other cases it is not. For one observes easily that in

[20] This statement is ordinarily true. Yet during the period of the Great War so many large industrial corporations were abnormally successful that many, having an accumulation of unpaid dividends on their preferred stocks, paid them off out of war profits.

each of the means adopted, the direct charges of the corporation are increased. And the advisability of the whole readjustment depends on whether or not this disadvantage is more than balanced by greater advantages.

When the earning capacity of an industrial corporation, previously unsuccessful, has been firmly established, the management may feel justified in offering the preferred stockholders an increase of income in return for the cancellation of their claim to unpaid dividends. This is the first method mentioned in the preceding paragraph. It is illustrated by the reorganization of the Interborough-Metropolitan Company in 1915, which, although not an industrial corporation in the sense used here, presents a clear case of such an adjustment. Owing to enormous losses in connection with the ownership of the stock of its subsidiary, the Metropolitan Street Railway, the parent company, did not feel like paying any dividends on the common stock while there existed a deplorable discrepancy between the par value of its shares and the net value of its assets.[21] Behind this lay the fact that the business at the time was improving. It might even warrant the payment of current dividends on the preferred stock, notwithstanding the fact that there was a large accumulation of unpaid dividends. The men in the management, who controlled the common stock, saw an opportunity to get dividends on their common stock if the incubus of the accumulated dividends on the preferred stock could be done away with. They recognized that they would never receive dividends if the accumulations on the preferred should be liquidated out of earnings. Accordingly the company proposed to give to its stockholders new 6 per cent non-cumulative preferred stock in exchange for the old 5 per cent cumulative preferred stock,

[21] Par value of stocks $139,000,000. Admitted value of assets $50,000,000. Even this $50,000,000 was excessive, as the $68,000,000 Collateral Trust Bonds represented all the value there was to the assets of the company—even taking the Interborough stock as worth $150 a share, a high valuation, and the New York Railways stock as worth $10 a share—so that the stocks represented in truth no "capital assets."

together with its dividend accumulations. The common shareholders were to receive new shares without par value, thus extinguishing the pretended money value of the common stock. In this manner the preferred stockholders were given a larger dividend and the common stockholders a chance to receive some return without waiting for the payment of the accumulated dividends on the preferred.[22] Clearly this method is applicable only when the management feels assured that the business of the corporation will in the future prove more profitable than in the past, as otherwise the increased preferred dividends will only lead to a more rapid dissipation of earnings, provided the dividends are paid; and if they are not paid nothing will have been gained by the reorganization.

More common and probably easier to accomplish is the method of effecting a compromise in the payment of the preferred dividends in arrears, by offering to give new securities of the company in lieu of at least a part of them. Sometimes the preferred stockholders are given non-interest bearing scrip, due, say, two years hence, in liquidation of their claims.[23] In this way a contingent liability is changed into a direct one, and at the same time the common stockholders are brought into a position to receive dividends when the current earnings warrant. In rare instances—and then only when the company bids fair to pass through a period of pronounced prosperity—the preferred stockholders are given interest-bearing bonds in exchange for their preferred claims; and instances are known in which the accumulated dividends have been partially paid off in money obtained from the proceeds of the sale of bonds.[24]

[22] See announcements made by the company at the time, as 5 N. Y. Times Annalist, 430.

[23] It was proposed in 1899 to liquidate 30 per cent of accumulated unpaid dividends on the preferred stock of the United States Leather Company by the issuance of 10 per cent in scrip.

[24] In 1913 the American Can Company's preferred stock had accumulated unpaid dividends amounting to 33 per cent. By cutting down the depreciation charge the company was able to show a substantial surplus on the basis of which it sold $14,000,000 of 5 per cent bonds to a syndicate of bankers. With the proceeds of these it paid off 24 per cent of the accumulated unpaid dividend on the preferred stock. On the anticipation of possible dividends, encouraged by the manipulation

Such readjustments, however, can hardly be called reorganizations, unless they are sufficiently comprehensive to involve considerable changes in the financial plan. The most comprehensive of these readjustments, involving an actual reorganization of the company, occur when there is a surrender of certain cumulative dividend claims attached to the preferred stock in exchange for some of the common stock relinquished by the common stockholders. As a result the preferred shareholders have a larger interest in the company, but the common shareholders—although possessed of a less number of shares—have a much more valuable security owing to the extinction of the preferred stockholders' claims to unpaid dividends.[25]

Much more serious changes in the organization of a company arise when the management funds the preferred stock, with its accumulated dividends, into bonds. Feeling that the future earnings of the corporation are assured, the directors, owning the common stock, seek, by the glamour of the word "bond" and by its stronger lien on earnings, to bribe the preferred shareholders to surrender their claims to unpaid dividends and to submit to a lowering of income.[26] Even

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of a powerful "bull clique" operating in the stock (the same interests who were responsible for the ruin of the Rock Island road), the New York Stock Exchange quotations of the shares were forced upward from $12 a share to $47 a share. For further details see Volume III, Chapter II, note 6.

[25] Distinctly the best illustration in recent corporate history of a reorganization in which the old preferred shareholders acquire a part of the common stock, is the final reorganization of the United States Leather Company into the Central Leather Company in 1905. The old United States Leather Company, organized in 1893, had met with only a modicum of success. After several plans of reorganization had been suggested and failed of adoption, the company found itself, in 1904, with accrued unpaid dividends of $43 a share on its $62,000,000 of 8 per cent cumulative preferred stock. A reorganization was consummated in which the preferred stockholders exchanged this 8 per cent cumulative preferred stock for half the par value in new 5 per cent First Mortgage Bonds and the other half in new 7 per cent cumulative preferred stock. The actual result was therefore a reduction from 8 to 6 per cent, or one-fourth, in the total charge ahead of the common stock, but of the new charge five-twelfths was fixed and the other seven-twelfths contingent. In exchange for the accumulated unpaid dividends, the preferred stockholders received 23½ per cent in a new common stock. To accomplish this result, the old common stockholders surrendered 70 per cent of their stock. Further details in Dewing, A. S., "The United States Leather Company and its Reorganizations," 26 Q. J. E., 68 (Nov. 1911); reprinted in Dewing, A. S., Corporate Promotions and Reorganizations, Chap. II (1914) and Ripley, W. Z., Trusts, Pools and Corporations, Chap. XI (1916).

[26] The difficulty of adjustment and the final working out of this principle is excellently illustrated by the reorganization of the United States Realty and Construction Company into the United States Realty and Improvement Company. The former corporation was organized for the primary purpose of building and operating New York real estate and the secondary purpose of speculating in the

without the necessity of a formal reorganization or even without an accumulation of preferred stock dividends as evidence of previous low earnings, this end may be accomplished, as was shown by the success with which the United States Steel Corporation induced its 7 per cent preferred stockholders to convert their stock into 5 per cent second mortgage bonds.[27] In this case, as in all others, the success of such a plan turns upon the balance, in the individual stockholder's mind, between a larger contingent return and a smaller fixed return. It should be noted, however, that such refunding operations are very dangerous for the corporation to enter into, as the actual debt is increased and the preferred stockholders become creditors capable of enforcing the payment of their interest by legal means. From every point of view the credit of the corporation is impaired.

Surveying this whole group of industrial reorganizations, consummated for the tacit purpose of eliminating the claims to unpaid dividends by the preferred stockholders, it is evident that we are dealing with attempts to simplify and unify the financial structure of a corporation. The preferred stockholders' claim to unpaid dividends is an anomaly. It is not a liability in the sight of the law or accountancy. Yet it

shares of other corporations. To further both purposes, $11,000,000 in money was subscribed by a syndicate. (Volume II, Chapter VII, page 114). The company had no direct funded debt, although there were mortgages on some of its buildings. Hardly a year after its organization the company was at least temporarily embarrassed by the depression in urban real estate and the fall in earnings of various of the corporations in the stocks of which it had speculative commitments. The corporate income was insufficient to meet the 7 per cent cumulative dividends on the preferred stock. Yet the common stockholders, who controlled the company, realized that the holders of the preferred would not consent to a reduction in dividend unless their claim became fixed instead of contingent. At first it was proposed to give the preferred stockholders 70 per cent of their holdings in 4½ per cent bonds, so that their income would be cut in half, then 60 per cent in bonds was suggested, then 35 per cent, and finally 50 per cent was agreed to, provided a bonus of 42½ per cent in new common stock was allotted them and the old common stockholders consented to a surrender of 85 per cent of the par value of their shares. In this way considerable sacrifices were endured by both classes of stockholders, but the total capitalization of the company was cut in two and the charges reduced about 60 per cent, although these were fixed instead of contingent.

[27] For full particulars of the United States Steel conversion, see articles by Meade, E. S., 18 Q. J. E. 22 (Nov. 1903); Whitney, E. B., 18 Q. J. E. 303 (Feb. 1904); Ripley, W. Z., 19 Q. J. E. 316 (Feb. 1905). Also U. S. Com. of Corporations Report on the Steel Industry, 1,348 (July, 1911). Parts of these documents are reprinted in Ripley, W. Z., Trusts, Pools and Corporations, Chap. VII (1916).

intervenes between the current earnings and any disbursements to the common shareholders quite as much as—and in some respects more than—an acknowledged liability. In every reorganization of this class, the effort was to do away with this anomalous situation and somehow bribe the preferred stockholders into relinquishing their shadow of a liability. And the compensation made to them varied according to the current prosperity of the company, the strength and vigor of the contract by which the preferred stock was originally issued, and—like all adjustments made by human beings—the relative obstinacy of the parties concerned. As a result, fixed charges were quite as likely to be increased as decreased, and the total admitted capitalization was likely to be larger than before the reorganization. From every point of view these reorganizations are in contrast to those carried out in the presence of a threatened financial crisis. This type represents the aftermath of blasted hopes, not a remedy for disaster.

The second of the great groups of industrial reorganizations are those planned primarily, often entirely, to relieve the corporation of an overpowering burden of floating debt. Until the recent practice of railroads in issuing short-term notes had brought about its evil consequences, failures and reorganizations resulting from an embarrassing burden of floating debt were confined to the history of industrial corporations. The long-established practice of the vast majority of industrials to carry at least a part of their quick assets by means of short-time loans from the banks, places the industrial in a peculiarly vulnerable position when the lending banks refuse to continue or extend the corporation's notes.

Peculiar difficulty is found in differentiating reorganizations of this class from all others, because the management of every embarrassed industrial alleges at the time that the difficulty is due entirely to the obstinacy of the banks, or their

inability to extend credit further. Were these diagnoses of the embarrassed corporations themselves to be taken at their face value, every industrial failure and reorganization would be of this class. But the diagnosis of the corporation is seldom correct. Other more fundamental causes usually underlie the withdrawal of credit. In some few instances, however, an unmanageable floating debt is the fundamental cause, just as the corporation's officials declare, but its existence is to be attributed much more probably to the stupidity of the management in allowing the debt to pile up than to the obstinacy or limitations of the banks.[28]

The crux of all reorganizations of this class is, obviously, the means to be taken to pay or to fund the floating debt.[29] A receivership is nearly always resorted to in order to prevent the possibility of attachments, so that there is ample time to consider the means available. If there is no mortgage on the property of the company, the easiest plan to execute—and for that reason the one most frequently followed—is to sell an issue of first mortgage bonds to bankers, and with the proceeds pay off the holders of the floating debt.[30] If the management and the stockholders are unwilling to do this, or if there already exists a mortgage on the property, then a reorganization has to be carried out which involves a direct as well as an indirect sacrifice on the part of the old security holders. In other words, the old stock or bondholders, or both, must suffer an assessment and take new junior securities in return; and with the proceeds of the assessment a part, or all, of the floating debt can be paid off. This is merely the use of the general principles already discussed under rail-

[28] It should be noted that as the central motive of the reorganization plans, described under this type, is to bring into control an unmanageable floating debt, the issue turns quite as often on the methods of obtaining new money as on the rearrangement of the financial structure. The methods, in general, of obtaining new money were discussed in the earlier part of this chapter.

[29] As stated in a previous note, these expedients were discussed earlier. No attempt will be made to repeat them here.

[30] As in the American Malting Company case, Chapter II, note 23.

road reorganization expedients, except that no particular effort is made to decrease the fixed charges.

One feature of industrial reorganization plans of this class intended to do away with an unmanageable floating debt, deserves at least passing notice. It is the provision in the vast majority of such plans to force the holders of the debt to take securities as a part of their claims. The old note-holders and merchandise creditors are asked to accept some percentage, perhaps 50 per cent, of their claims in cash and the rest in long-term notes—usually of various maturities. The creditors ordinarily accept this compromise. They recognize that by forcing the corporation into bankruptcy they can undoubtedly secure the collection of at least a part of their claims, but the remaining part will be forever lost. Whereas, if they show a willingness to co-operate with the stockholders to the extent of funding a part of their debt into one-, two-, or even five-year notes they give the stockholders an opportunity to work out the rehabilitation of the company, and with its rehabilitation the creditors can ultimately secure the full payment of their obligations. At least, this is the kind of argument advanced to them and to which they are usually amenable.

The third class of industrial reorganizations, which are consummated for the avowed purpose of lessening the fixed charges, are invariably the result of failure. If the failure is not serious, or if the corporation has merely shown a continued low earning power while its affairs have never reached a serious crisis, it is sometimes possible to induce bondholders to consent to a lessening of the principal and interest of their bonds.[31] But ordinarily bondholders will not endure even a

[31] The National Starch Company found itself unable to meet the interest on a 6 per cent bond of one of its subsidiary companies. The Corn Products Refining Company, which owned the stock of the National Starch Company, consented to guarantee the principal and interest on the underlying Starch bond, provided the bondholders submitted to a 16⅔ per cent reduction in the principal of their bonds and a lowering of the interest rate from 6 per cent to 5 per cent.

nominal sacrifice without coercion, and the various steps of default, receivership, and foreclosure sale have to be followed in order to compel the bondholders to submit to a lessening of their charges. When such steps are necessary, the industrial reorganization differs, as far as the plan is concerned, but little from the typical railroad reorganizations discussed in the previous chapters. There is, perhaps, a little greater tendency to deal harshly with bondholders in requiring them to exchange bonds for stock, but the general principle that industrial enterprises ought not to have bonds in their financial plan is ample excuse for taking advantage of the opportunity of a reorganization to eliminate entirely the funded debt. At all events the principle holds true, as in railroad reorganizations, that the corporation must be relieved from the burden of fixed charges in order that it may strengthen its own internal organization and its mercantile credit. Permanent strength can be obtained only through a period of rest and reconstruction. And this principle, in spite of the varying circumstances of its application, must be the paramount motive in every industrial reorganization where failure is to be attributed primarily to a burden of fixed charges.

In these reorganizations involving a decrease or the entire cancellation of the funded debt, the problem always turns on the kind of security the bondholders are willing to accept. If the security offered is not satisfactory to them they are in a position to force the liquidation of the assets of the corporation. This result would give the bondholders the little that there was and the stockholders nothing. Even at the time of involuntary reorganizations, therefore, some advantages must be attached to the new stocks offered in exchange for the old bonds—or the stockholders must otherwise strengthen the corporation's credit—else the bondholders will not accept them. These advantages are, on the one hand, a heavy cash payment by the old stockholders into the treasury

of the new company in exchange for a second preferred or common stock, and, on the other hand, the acceptance by the old bondholders of a new first preferred stock or an income bond. The rate on the contingent charge security offered the old bondholders is ordinarily a little higher than that carried by the old bonds. A higher contingent rate is exchanged for a lower fixed rate.[32] Furthermore the new preferred stocks are seldom immediately cumulative in their dividend demands; yet, in order to protect the new preferred stockholders from the avarice of the common stockholders who maintain control, the preferred stock dividends are often made cumulative after a period sufficiently long to enable the reorganized company to have fully regained its credit.[33]

Whatsoever may be the primary purpose of the reorganization, whether to benefit one class of the security holders or the general credit of the corporation through a lessening of the fixed charges, a voluntary reorganization is to be preferred to a receivership and foreclosure sale. Even more

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[32] In six industrial reorganizations in which bonds were exchanged for stock five of the stocks were preferred carrying equal or greater charges. Dewing, A. S., Corporate Promotions and Reorganizations, 608 Table, 1c (1914).

[33] All these principles are well illustrated by the reorganization of the International Steam Pump Company in 1915. This company was formed in 1899 as a combination of some steam pump plants, including some of the best in the country. It had no bonded debt of its own, although a subsidiary had debentures outstanding of about one million dollars. During the earlier years of its history it is to be considered as one of the more successful of the so-called "trusts." The 6 per cent cumulative dividend on the preferred stock was paid continuously down to May, 1913, and was, at one time, quoted as high as 95 per cent on the New York Stock Exchange. In 1906 the company embarked on an era of expansion through the purchase, at a factitious figure, of the Power and Mining Machinery Company. In 1909 $9,500,000 First Mortgage Bonds were issued to fund an accumulation of debentures and floating debt. Nevertheless through the misdirected efforts of the men who assumed control—apparently unfamiliar with the steam pump business—this new period of broadened activity resulted in failure.

Just before the failure a committee of the Henry R. Worthington preferred shareholders (a subsidiary of the International Company) reported "that because of ill-considered or interested advice, or bad management your company has been loaded with a very large indebtedness, affecting your interest, the propriety of which may be seriously questioned." Woodward Committee Report.

In the resulting reorganization a new company was formed without bonded debt. The old stockholders, both preferred and common, were assessed $12 a share. In return for their cash assessment they received new first preferred stock, and for their old stock a small allotment of new common stock. The old 5 per cent First Mortgage bondholders were granted new 6 per cent second preferred stock which was non-cumulative for the first three years and cumulative thereafter.

than with railroads and other public service corporations, the notoriety of failure, bankruptcy, and litigation impedes the normal business of an industrial corporation. Its general credit, including its banking facilities, is hurt; especially is its general trade standing imperiled. The internal operating force and the selling force become disorganized, careful as the receiver may be. Customers avoid business dealings with an insolvent concern.[34] Fully conscious of all these considerations, those in control of the business will seek to effect a "friendly" reorganization, in which the impending crisis is relieved by voluntary purchase of junior securities by one or more classes of security holders. This is not possible if, as in the case of most large railroads, there are a host of creditors and conflicting interests, but such a solution is, unquestionably, possible at the time of a crisis in an industrial or even small public service enterprise, if the various security holders and creditors are on friendly terms and not too widely scattered. Friction and sometimes almost insurmountable differences of opinion can be overcome if the affairs of the company happen to rest in the hands of a few keen-sighted men of conciliatory disposition. In the effort to bring about a "friendly" reorganization of an industrial corporation, a committee of the management usually sends to the various interests a plain statement of the actual facts. Perhaps the floating debt is too large and should be funded by voluntary

[34] All these matters are illustrated by a comparison between the business of the Westinghouse Electric and Manufacturing Company and the General Electric Company during the years preceding and following the receivership of the former.

	General Electric	Westinghouse
Year before Receivership:		
Gross Sales	$60,072,000	$33,026,000
Manufacturing Profits	6,965,000	4,180,000
Year after Receivership:		
Gross Sales	44,541,000	20,607,000
Manufacturing Profits	2,891,000	651,000
Percentage Decline in Sales	26%	33%
Percentage Decline in Profits	58%	84%

These figures are all the more remarkable because the Westinghouse reorganization was voluntary, and every effort was made to preserve in fact all the intangible assets of a going business.

action on the part of the stockholders, or perhaps the company is too heavily capitalized and a voluntary cutting down of the stock issues is necessary.[35] Whatever the conditions, they are carefully explained to the security holders and the remedy is pointed out, which invariably involves some direct or indirect sacrifice on their part. If a sufficient number agree to the plan it is declared operative and the managers proceed to put it into execution. There will be always some security holders who will refuse to agree to the sacrifice. These will either be bought off or "carried" by the others. In such a case there is no receivership, no conflict of opposing interests represented by numerous committees, no foreclosure sale, and no reincorporation under a new name.

[35] Second reorganization of the American Malting Company, *supra*.

INDEX

GENERAL INDEX

VOLUMES I—V.

GENERAL INDEX

J

L

M